THE FUTURE OF HOUSING IN AMERICA: OVERSIGHT OF THE FEDERAL HOUSING ADMINISTRATION—PART II

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND INSURANCE

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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THURSDAY, FEBRUARY 26, 2015

APPENDIX

THE FUTURE OF HOUSING IN AMERICA: OVERSIGHT OF THE FEDERAL HOUSING ADMINISTRATION—PART II

Thursday, February 26, 2015

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING
AND INSURANCE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:01 a.m., in room 2220, Rayburn House Office Building, Hon. Blaine Luetkemeyer [chairman of the subcommittee] presiding.

Members present: Representatives Luetkemeyer, Westmoreland, Royce, Garrett, Pearce, Hurt, Stivers, Ross, Barr, Rothfus, Dold, Williams; Cleaver, Velazquez, Capuano, Green, Moore, and Kildee.

Also present: Representative Sinema.

Chairman LUETKEMEYER. The Subcommittee on Housing and Insurance will come to order. Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Before we begin, I would like to thank the witnesses for traveling to 2220 Rayburn for today's hearing. I apologize for the confined quarters, but they tell us that we are going to be able to get into these new remodeled, wonderfully decorated environments here shortly. And we will see. If it is like everything else around here, maybe August. But we will try.

The audio-visual system in the Financial Services Committee hearing room is being replaced. And so, we are going to just bear with that for a short period of time here.

Today's hearing is entitled, "The Future of Housing in America: Oversight of the Federal Housing Administration—Part II." We had a hearing a couple of weeks ago with Secretary Castro, and it was very enlighting with regards to his interest and his informational working knowledge of his own agency, which was, quite frankly, embarrassing.

But anyway, I know that all of you today are very well-versed on your subjects. And we are looking forward to that.

With that, I recognize myself for 3 minutes for an opening statement.

Earlier this month, the Financial Services Committee received the testimony of HUD Secretary Julian Castro in part I of the hearing we hold today. His testimony, or lack thereof, was alarming. Let me be clear from the start. I support the underlying mission of the Federal Housing Administration. There is a purpose for the agency. Some qualified first-time and low-income individuals and families need assistance in securing their first home.

But FHA has suffered a severe case of mission creep. And the unfortunate truth is that the lack of sound underwriting and risk management puts both homebuyers and U.S. taxpayers at risk. Today, FHA falls far short, in my opinion, of its required capitalization level in the Mutual Mortgage Insurance Fund, or MMIF, pulling only four-tenths of a percent capital, instead of the salutorily-required 2 percent.

When you remove the $1.7 billion taxpayer bailout of FHA and the billions of Justice Department settlements that pad FHA's books, the MMIF capital level falls to a dismal .08 percent. We are told time and time again that FHA finds itself in its current fiscal situation because of the financial crisis. But FHA's shaky principles were not born out of the crisis alone. In fact, since 2000 FHA has hit the targeted economic value for MMIF only twice.

We should take little comfort in FHA's projections that all is well and will get better. We have heard it for years, and it has never proven to be the case. In 2009, then-HUD Secretary Shaun Donovan said FHA would reach the capital requirement in the next 2 or 3 years. That didn't happen. In 2011/2012, he said FHA would hit the target in 2015. We are nowhere close to those targets today, despite no catastrophic changes to the housing market.

The underlying problems at FHA have existed for years, and continue to pose a threat to all Americans. If a private business like the ones represented on our panel today operated in a similar fashion to FHA, it would be placed into receivership. Yet, FHA continues unapologetically down a dangerous path that we have traveled before.

To make matters worse, the agency has decided to cut its income stream by lowering premiums. Anyone who understands the fundamentals of lending and insurance knows you can't cut your income stream when you are in desperate need of capital. The bottom line is that FHA keeps trying to grow itself out of a problem. That hasn't worked in the past, and isn't going to work this time. We need to focus on common-sense reform and the creation of a more stable housing market and housing finance system.

I look forward to hearing all of our panelists today and continuing this important discussion.

And with that, I yield 3 minutes to our ranking member, Mr. Cleaver from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman. And to our panelists, thank you for being here.

Today we have convened a hearing entitled, "The Future of Housing in America: Oversight of the Federal Housing Administration—Part II." Our full Financial Services Committee held a similar hearing earlier this month and received testimony from Secretary Castro regarding the current state and plans of FHA. We are here now to hear private sector perspective on the recent actions undertaken by the FHA.

I have never been shy about my support for homeownership, having some difficulty as a boy growing up in terms of our homeownership and having lived in public housing. I think that it provides people with a level of "somebody-ness" that they might not otherwise get. It encourages families to become neighbors, and it creates neighborhoods.

Recently, the FHA announced that it would lower the mortgage insurance premiums by .5 percent from 1.35 percent to .85 percent. And though this is a reduction in fees, the premiums—and I think this is important—are still 50 percent higher than they were before the financial crisis. Though the FHA has weathered stinging criticism for this action, the decision was not made in a vacuum.

Other changes were made at FHA, and they have increased the stability of the MMFI fund, resulting in a pool of strong borrowers. For example, the FHA now requires premium payments for the entire life of a loan. A credit score floor has also been introduced. And a 10 percent downpayment is now required for credit scores below 580.

Again, I would like to welcome our witnesses. The private mortgage insurance market plays a very, very significant role in our housing market. And I look forward to hearing from the panelists. Thank you for being here today.

Chairman LUETKEMEYER. Thank you. I think we also have the gentleman from Texas, Mr. Green, who would like to have 2 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I thank the ranking member, as well. And I also thank the witnesses for appearing today.

I would like to, if I may, just take a moment to cite the Center for American Progress, because I am interested in hearing more about what they are presenting today. On page four of your presentation, you indicate that FHA has increased its annual mortgage insurance premiums significantly, even after the recent decrease, which is what our ranking member talked about just a moment ago.

After the decrease announced in January by President Obama, the annual fee is still 50 percent more than it was in 2008. It has also raised its up-front insurance fee by 75 percent and required that the premiums be paid for the life of the loan, rather than being cancelable when the loan reaches a 78 percent loan-to-value ratio. I think that is important. I would like to hear more about that.

And finally, over on page nine you make a significant statement, that even after the premium cut, the Office of Management and Budget, or OMB, projects that the new loans in Fiscal Year 2016 will make a net profit to taxpayers of 3.7 percent on average on an average FHA; that is a gross profit to the taxpayers of $6.423 billion.

It appears to me that FHA is on its way back. And I am proud to be associated with FHA. I believe in FHA. I believe that this hearing can be very meaningful if we are talking about strengthening and improving FHA.

I yield back.

Chairman LUETKEMEYER. Thank you.

With that, we want to welcome today's guests: Dr. Douglas Holtz-Eakin, president of the American Action Forum; Mr. Rohit Gupta, president and chief executive officer at Genworth Mortgage

Insurance, and chairman of U.S. Mortgage Insurers; Ms. Julia Gordon, director of housing and consumer finance, the Center for American Progress; and Dr. Clifford Rossi, professor-of-the-practice and executive-in-residence, the Robert H. Smith School of Business, the University of Maryland, and chief economist of Radian Group, Inc.

Thank you all for being here today. I look forward to your testimony. Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. And without objection, each of your written statements will be made a part of the record.

Dr. Holtz-Eakin, you are first. You are recognized for your 5 minutes. Welcome.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, PRESIDENT, AMERICAN ACTION FORUM

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman, Ranking Member Cleaver, and members of the subcommittee. It is a privilege to be here today to discuss—I will make three points very briefly, and I look forward to your questions.

Point number one is that the FHA mortgage insurance fund remains in perilous financial shape. As the chairman mentioned at the outset, the current capital ratio is .4 percent, well below the statutory requirement of 2 percent. And that .4 percent has been bolstered by a series of one-time infusions of about $4 billion: $1.7 billion from the U.S. Treasury; and $2.3 billion from one-time settlements of lawsuits.

And the projection that it will hit the 2 percent required ratio by 2016 is one in which I don't think we can place a lot of confidence. There is a history of mis-projections outlined in my testimony and Dr. Rossi's testimony, as well. And I think that the committee should be quite cautious about counting on that projection becoming a realty.

The second major point is that the recent premium reduction appears quite unwise. Number one, it cuts into the revenue stream for an insurance fund that is short of capital. Number two, it shifts the capital away from the private sector. Inevitably, this is going to cut into the private mortgage insurance market. There has been in the aftermath of the financial crisis a bipartisan agreement that it would be wise to bring private capital into backing mortgages and have less reliance on the taxpayers as a backstop. This goes against that.

And in the process, it will shift the risk of the portfolio in a bad direction. The people most likely to take advantage of this are going to be high-loan-to-value, high-risk borrowers. And the quality of the portfolio will be worse than it would otherwise be in the absence of this reduction.

I find it puzzling that this reduction was done in such a rapid fashion. If you look at the history of changes in the premiums, this was done in 9 business days, far from the typical pace at which there is some chance to comment on the wisdom of such a change. So, I think the committee is wise to revisit this.

And then more generally, I think this is a reminder of the need for this committee and the Congress as a whole to undertake a comprehensive revision to the GSEs and the FHA. In the last Congress, the Financial Services Committee did a lot of work on the Path Act. I commend the committee for that. But the overall job remains undone.

And it is not enough to look at premiums or the FHA mortgage insurance fund in isolation. The entire backstop for mortgage financing in the United States needs a rethinking with the hope that the FHA will end up with a mission that is clearly defined, one where assistance is well-targeted, and where capital adequacy is restored.

So I thank you for the chance to be here today, and I look forward to your questions.

[The prepared statement of Dr. Holtz-Eakin can be found on page 72 of the appendix.]

Chairman LUETKEMEYER. Thank you, Dr. Holtz-Eakin.

Next, we have Mr. Gupta. And you have 5 minutes.

STATEMENT OF ROHIT GUPTA, PRESIDENT AND CHIEF EXECUTIVE OFFICER, GENWORTH MORTGAGE INSURANCE, AND CHAIRMAN, U.S. MORTGAGE INSURERS (USMI)

Mr. GUPTA. Chairman Luetkemeyer and Ranking Member Cleaver, thank you for the opportunity to testify this morning.

My name is Rohit Gupta. I am the president and CEO of Genworth Mortgage Insurance. I also serve as the chairman of U.S. Mortgage Insurers, a trade association that began—USMI represents six of the industries, seven private mortgage insurers, and is based here in Washington. As private mortgage insurers, we play both a complementary role, as well as a competitive role with the FHA by making it possible for home-ready borrowers to buy a home without saving for a 20 percent downpayment.

In my testimony this morning, I am going to cover three topics: first, how private mortgage insurance works and how our industry differs from the FHA; second, how we weathered through the housing crisis and the lessons we have learned; and third, how our industry is positioned to play a bigger role moving forward.

Mortgage insurance (MI) is the primary form of private capital-backed credit enhancement for low downpayment loans. We are regulated by State departments of insurance, who oversee our business conduct. They also set our pricing and review our capital requirements at a risk-to-capital ratio of 25:1, or 4 percent of risk insured. In addition, Fannie Mae and Freddie Mac set additional qualification criteria that we must satisfy in order to be eligible to do business with them.

Today, private MI's insure loans with downpayments as low as 3 percent for borrowers with FICO scores as low as 620. We underwrite loans based on a variety of factors. Our underwriting is grounded in the three Cs: credit; capacity; and collateral. In the past year, U.S. Mortgage Insurers helped almost 600,000 borrowers purchase or refinance their homes. Almost half of the homes we insured were for first-time homebuyers, and 40 percent went to borrowers with incomes of less than $75,000.

On the other hand, the FHA's primary mission is to target low- and moderate-income borrowers, members of underserved communities, and first-time homebuyers. The insurance fund is subject to a minimum statutory requirement of 2 percent of the risk insured.

And their capital ratio, as the chairman stated, is currently at .41 percent, a fifth of the minimum required.

The very business of the private mortgage insurance industry is to put our own capital at risk in the first-loss position. This matters for several reasons. First, because we put our own capital at risk, we have a powerful incentive to verify that the loans that we insure are prudently underwritten and they are sustainable. Our capital at risk aligns our interests with those of borrowers, mortgage lenders, investors, and the overall housing market.

Second, taxpayer risk is extremely remote on the loans we insure. If a loan goes into default, borrower equity and our MI claim payment stand ahead of any GSE guarantee. In many cases, losses to the GSEs are far less on defaulted loans with MI than on loans that actually do not have MI coverage in front of them.

Third, the MI business model builds capital during strong markets. And that capital becomes available to pay for losses in weak markets and in times of stress. Today, our industry is highly-capitalized and is well-positioned to pay claims and write new business.

Like all of the housing finance market, our industry faced unprecedented challenges in the recent housing crisis. But USMI member companies never stopped paying claims, and we never received any bailout money from the Federal Government.

Since the GSEs went into conservatorship, our industry has covered $51 billion in claims. Let me repeat that. Our industry has covered $51 billion in claims, out of which $44 billion went to GSEs alone, claims that otherwise would have been on the shoulders of taxpayers. And we have attracted approximately $10 billion of new capital in the industry.

Coming through the housing cycle, we addressed many of the lessons we learned. We have significantly shored up our capital. All MI companies at this point are operating at capital ratios of 5 percent or better. In October 2014, we also implemented new master policies and new contracts that give more certainty around how and when we pay our claims.

Later this year, the GSEs and the FHFA will finalize revised Private Mortgage Insurer Eligibility Requirements (PMIERs). These revised PMIERs will include new risk-based capital requirements that will be significantly higher than our current capital requirement.

The committee asked us to comment on the FHA's role as it relates to reentry of private capital. FHA and private MIs can and should serve as complementary forces that enable the FHA to remain focused on it goal of serving underserved communities, especially the communities that the private sector is not suited to reach.

But for this model to work, it is critical that FHA not stray too far from that mission. The recent decision to lower annual insurance premiums at FHA, for example, has two immediate consequences: first, it slows the path of FHA to reach its 2 percent minimum capital requirement; and second, it limits the ability of private mortgage insurance companies to serve the market. Both of these actions will increase the exposure of taxpayers to housing risk. And both are directly in contrast to FHA's own stated goal of bringing more capital into the housing market.

To summarize, the private MI industry is in the best position to continue to serve the housing market as it exists today and as housing is reformed going forward. The current application of standard cover private mortgage insurance is a very good place to start, as recognized in most of the GSE reform efforts included in the 113th Congress.

But more can be done to make the risk for the Federal Government even more remote. In addition to standard cover, encourage supplemental or deeper private mortgage insurance to further distance the government exposure, and encourage the use of additional risk-sharing to transfer real risk from the government balance sheet, both the GSEs and the FHA, over to private MIs.

As Congress continues the important work on comprehensive housing finance reform, we strongly believe that reform should include: a common-sense approach to FHA loan limits; current home prices in each geographic region; a single industry-wide standard on Qualified Mortgages; and a single industry standard for permissible seller concessions.

We appreciate the opportunity to testify this morning and look forward to responding to any questions you may have.

[The prepared statement of Mr. Gupta can be found on page 64 of the appendix.]

Chairman LUETKEMEYER. Thank you, Mr. Gupta.

Ms. Gordon? You have 5 minutes.

STATEMENT OF JULIA GORDON, DIRECTOR, HOUSING AND CONSUMER FINANCE, CENTER FOR AMERICAN PROGRESS

Ms. GORDON. Good morning, Chairman Luetkemeyer, Ranking Member Cleaver, and members of the subcommittee. Thank you so much for convening this hearing on the Federal Housing Administration, which is more important than ever to provide responsible mortgage credit for borrowers who cannot afford a large downpayment or whose neighborhoods are not well-served by the conventional market.

This morning I want to talk about three things: the high credit quality of today's FHA loans; the important role the agency is playing in supporting the housing market; and the agency's financial health.

Throughout its history, FHA has supported mainly plain vanilla, long-term, fixed-rate mortgages with no resets and no prepayment penalties. Even in the run-up to the crisis, FHA never insured the toxic loans securitized by Wall Street. Those loans featured extremely low teaser rates with steep resets, prepayment penalties that locked people in beyond the reset dates, and numerous other confusing features, such as the pick-a-pay mortgages where people could pay an amount that didn't even cover principal and interest.

While many of these predatory loans had low downpayments, those low downpayments were layered with multiple additional risks and had little or no underwriting done. Many of these products are now prohibited by the Dodd-Frank Act mortgage rules.

Studies show that portfolios of properly-underwritten low downpayment mortgages performed well, even throughout the Great Recession. And since the crisis, FHA lending has become even safer. As Ranking Member Cleaver noted before, FHA now specifies a minimum credit score, requires a much higher downpayment for borrowers with credit scores below 580, and requires manual underwriting for several other potentially riskier categories.

What is more, contrary to a discussion in this committee when HUD Secretary Castro was here, FHA loans do follow the Dodd-Frank Act's requirement that lenders assess a borrower's ability to repay before making that mortgage. And, in fact, Dodd-Frank required FHA to issue its own parallel safe harbor standard, what some people call the QM standard, the same as the Consumer Financial Protection Bureau (CFPB) had created for the private market. Loans made under these policies will have an extremely high chance of success. And, in fact, the independent actuary projects that the books of business from recent years will be among FHA's most profitable in its history.

FHA also plays a very important role in supporting the market throughout the business cycle. If FHA had not been around to provide liquidity when private capital withdrew from the market in 2008, home values might have declined twice as far as they did, potentially causing a double-dip recession and far higher unemployment rates.

Now, that countercyclical role that FHA played was not without cost. And it took a serious toll on the insurance fund. But a combination of strong management, policies that reduce risk, and a number of premium increases have put the agency back in the black now in a relatively short timeframe. Those who claim that HUD may be violating the law by reducing its annual premium at a time when the ratio has not yet returned to 2 percent are taking that ratio out of context of the entire statute.

The statute says that when the insurance fund is undercapitalized, the HUD Secretary may propose any adjustments to the insurance premium, but must consider FHA's capital requirements alongside other operational goals, including meeting the needs of homebuyers with low downpayments and first-time homebuyers by providing access to mortgage credit.

FHA had gotten into a situation where the amount that it had raised its premiums by was causing borrowers to pay about $17,000 in premiums for less than $5,000 in risk. Clearly, things had gotten out of whack. And the .5 percent reduction in just the annual premium, without even touching the up-front premium or changing the new requirement that premiums be paid for the life of the loan, was a modest and sustainable way to readjust that overcharging without materially changing the date by which FHA expects to get back to its capital ratio.

I want to close by mentioning a couple of important areas where I think FHA can reduce risk further to the taxpayers, while enhancing access to mortgage credit for qualified households and strengthening neighborhoods.

One is encouraging and funding broader availability of housing counseling. FHA had developed a pilot program to do this, called the Homeowners Armed With Knowledge (HAWK) program, which would have connected new homebuyers with high quality housing counseling. But unfortunately, Congress used the Fiscal Year 2015 spending bill to prohibit FHA from implementing HAWK. I urge Congress to reconsider this decision.

My organization has also recommended a series of changes that HUD can make to its distressed assets sales program to keep more homeowners in their homes and better support neighborhood restoration.

Finally, when it comes to competition with the private sector, I think it is very important that we look across both FHA and the GSEs. The GSEs right now are engaged in some very steep risk-based pricing that is new to them. They just started this after the crisis. If they were to readjust that pricing back to pre-crisis levels, I think private mortgage insurers would be in a much better competitive position. And I think when we talk about pricing generally, it is important to look across both FHA and the GSEs.

With that, I look forward to your questions. Thank you again.

[The prepared statement of Ms. Gordon can be found on page 44 of the appendix.]

Chairman LUETKEMEYER. Thank you, Ms. Gordon.

Dr. Rossi, you have 5 minutes.

STATEMENT OF CLIFFORD V. ROSSI, PROFESSOR-OF-THE-PRACTICE AND EXECUTIVE-IN-RESIDENCE, ROBERT H. SMITH SCHOOL OF BUSINESS, UNIVERSITY OF MARYLAND; AND CHIEF ECONOMIST, RADIAN GROUP, INC.

Mr. ROSSI. Thank you. Chairman Luetkemeyer, Ranking Member Cleaver, and members of the subcommittee, thank you very much for inviting me to testify today.

My testimony is actually going to focus on three areas: concerns with the actuarial report; the impact of the FHA's decision to lower mortgage insurance premiums; and recommendations on reforming FHA.

As you have heard, the MMIF is in an extremely weak position. The 2014 actuarial report estimates that the fund will actually reach the 2 percent capital reserve ratio threshold by 2016. However, the report relies on an extraordinarily complex model to reach that conclusion, and it did not factor in the recent 50 basis points reduction in the annual premium for new loans and eligible refinanced loans.

Unfortunately, flaws in the model raise serious questions about that conclusion. Let me just highlight three of these. First, it does not appear that the FHA tested its models for accuracy using data that was used to develop the model itself, such as different samples of loans. As a result, the model appears to have far less predictive ability than we would hope.

One example is that the diagnostic statistic used to forecast national home price changes, which happen to be a major factor explaining mortgage default, are not viewed as typically having a particularly strong prediction.

Second, a key piece of information used to develop FHA's credit risk profile of future risks and business was provided by HUD, rather than the actuary or another independent source. So in my opinion, this actually calls into question the validity of the estimate.

And then third, the approach taken for generating an estimate of the economic value of the fund requires estimating borrower defaults as a function of home prices, interest rates, and unemployment rates. The process of simulating various possible macroeconomic outcomes is called a Monte Carlo simulation. This is a valid approach. But the number of possible outcomes used in the report is woefully insufficient. The FHA actually used only 100 simulated paths. Compare that to a recent study of the fund by the CBO, which simulated 1,000 economic paths.

Beyond the flaws in the report, the FHA's recent decision to reduce its premiums will exacerbate the funds's financial condition and extend the time to build the 2 percent capital reserve.

The FHA premium reduction also disadvantages private capital that is currently in the market. Let me illustrate. With the FHA premium reduction, borrowers with a 5 percent downpayment and a FICO score of 680 or above are at risk of going to FHA when previously, private mortgage insurance was a great option for them. In my estimate, approximately 8 percent of private mortgage insurance is at risk of being taken by FHA if pricing or execution are the only factors in the decision.

So you might ask why private mortgage insurers don't simply reduce their premiums to match FHA. But this question ignores a fundamental difference between the two: FHA does not have to cover its cost of capital, because it has none.

So finally, Mr. Chairman, I would like to actually quickly highlight a few specific FHA reform recommendations.

First and foremost, FHA needs to get back to its historical focus of providing access to mortgage credit for low- and moderate-income borrowers. Under normal conditions, FHA should stick to its historical share of about 10 to 15 percent of the downpayment market—low downpayment market. To accomplish this, FHA should adopt an area median income target to determine program eligibility and should phase out the use of area-based loan limits.

Second, FHA should be permitted to engage in risk-sharing arrangements. Private mortgage insurance provides first-loss coverage between 25 and 35 percent, protecting the GSEs, and thus the taxpayers. But FHA still holds 100 percent of the credit risk.

The benefits of risk-sharing are widespread from a taxpayer protection standpoint, as well as introducing some degree of private sector discipline and price discovery into the process. FHA should immediately begin testing a wide variety of credit risk transfer structures with MI companies and other qualified counterparties.

Third, we have to endeavor to view FHA policies and GSE policies in tandem if we are at all serious about adopting a consistent national homeownership policy. Right now, FHA and GSEs use different numbers in calculating key metrics in their respective risk models, which allows them to draw different conclusions about how to price future risk and the fees associated with that insurance. Those calculations should be the same in order to avoid incongruous pricing policies between the agencies and the FHA.

So in conclusion, let me just state this and emphasize this: Without question, FHA has been and is an essential part of the housing finance system. While maligned for the current financial challenges of the fund, it is important to keep in mind that FHA has served this country well for nearly 80 years. But it has strayed from it historic mission. And the result has been to deplete the fund and to undercut the role of private capital in the market.

Thank you for the opportunity again. And I look forward to any questions that you may have for me.

[The prepared statement of Dr. Rossi can be found on page 79 of the appendix.]

Chairman LUETKEMEYER. Thank you, Dr. Rossi.

We have a situation this morning with this new room. And I apologize to all the folks who are here in the cramped quarters. But we also have a problem with our Members on the dais here from the standpoint of our clocks. My clock doesn't work. The clock in front of Mr. Stivers, which I can see since I do have my bifocals on, is apparently working. And apparently, you all don't have any clocks at all. Is that correct? Okay.

What I am going to do is, I will watch the time. And we will try and be as judicious as possible. But when we get to the 30-second mark where you are without time—in other words, when you get down to about 4 minutes and 30 seconds of your time, I will tap this gavel to let you know you have 30 seconds left so that you can have some time to sort of wrap up your questions or know where you need to be going with it. But we will try to work with you on the time here. This is very inconvenient. But if everybody sort of works together, I think we can get through this.

Let me recognize myself for 5 minutes and begin the questions with Dr. Holtz-Eakin here.

I appreciate your testimony today. And I am kind of curious. I was reading through your testimony. And in the testimony—well, let me ask this question first. Two weeks ago, Secretary Castro was in front of us. And he truly believes that the projected mortgage premium is not going to hurt FHA and that they will still be able to come up with enough money, and can grow themselves out of this mess. Can you give us your educated opinion on this, please?

Mr. HOLTZ-EAKIN. I would make two points. The first is that historically that has just not been true. If you look at the projections—the chart in my testimony is pretty clear on this—again and again, there is a forecast of reaching capital adequacy. And again and again, FHA falls short. So I just think that if you are a prudent curator of the taxpayers' money, you can't really count on that forecast, and you shouldn't.

The second point is that what the Secretary is essentially saying is that we can cut our prices and raise our revenue. And it is similar to assertions that were often disdained by the Administration, that you can cut taxes and raise revenue. It is exactly the same argument in a different setting. And I don't think it has any more credence coming from the Secretary than from anyone else.

Chairman LUETKEMEYER. In your testimony, there is a chart there that shows that over the last—well, since January of 2010 there have been eight increases and one decrease. So I assume that whenever they increased premiums, the revenue went up.

Mr. HOLTZ-EAKIN. Yes.

Chairman LUETKEMEYER. How did this affect the volume of loans that were being mad? Did it go up or down?

Mr. HOLTZ-EAKIN. It is hard to isolate just the premium impact, quite frankly, because we have been through this extraordinary housing cycle. And so the share of FHA market went up in large part because of the cycle. I think you have to pull that out. And in general, it is going to—if you raise the premium, you are going to shift things into the private sector and let the private market back it.

Chairman LUETKEMEYER. Okay. So whenever they decreased premiums, what happened?

Mr. HOLTZ-EAKIN. It is going to cut into the FHA and put the taxpayer behind it.

Chairman LUETKEMEYER. So basically, the one time they did decrease it, did it increase volume?

Mr. HOLTZ-EAKIN. Yes.

Chairman LUETKEMEYER. The volume of loans went up?

Mr. HOLTZ-EAKIN. Yes.

Chairman LUETKEMEYER. But how much—

Mr. HOLTZ-EAKIN. —but how much it raised revenue—I could get back to an exact number.

Chairman LUETKEMEYER. Okay. I was just kind of curious. Because I was doing some numbers here, just to try to come up with some—let's say they start out with $100. And they cut their premiums roughly 40 percent. I believe that is correct.

Mr. HOLTZ-EAKIN. Sure.

Chairman LUETKEMEYER. So that makes 60 percent of the revenue that they had been taking in, which means in order to get back that hundred dollars, they would need a two-thirds increase in the volume of loans. Is that—is my—

Mr. HOLTZ-EAKIN. That is right.

Chairman LUETKEMEYER. —math correct here? Okay.

They have roughly a trillion dollars worth of loan portfolio right now, so they would have to have then roughly a $1.67 trillion or almost $1.7 trillion portfolio to still make the same amount of money—

Mr. HOLTZ-EAKIN. Right.

Chairman LUETKEMEYER. —to be able to get back to where they were and get back to the projections of meeting their capital by 2016. Is that—am I—

Mr. HOLTZ-EAKIN. You are doing that right.

Chairman LUETKEMEYER. Okay. So the problem is—as I think, Dr. Rossi in your chart, and also Dr. Holtz-Eakin indicated here on the previous page, everything under 680 is where FHA is going to be competent and be competitive. And therefore, it would seem to me they are going to take all of the risky loans. And the private market then would be able to be more competitive on the upper loans. So you are taking two-thirds more—you are increasing your loan portfolio by two-thirds and increasing the riskiness significantly. Am I missing something here?

Mr. HOLTZ-EAKIN. That is one of the concerns that I tried to highlight at the outset.

Chairman LUETKEMEYER. So it seems to me that we are going the wrong direction fast. And if we are taking on more risk, do you think that our reserve is adequate there to handle the increased risk? Or the risk we have right now, quite frankly.

Mr. HOLTZ-EAKIN. No. In the past, I have expressed my concern that even 2 percent isn't an adequate capital ratio. Certainly, the fund is well below that now, and has taken steps to diminish its ability to get to two percent.

Chairman LUETKEMEYER. Mr. Gupta, I think that the private market—you are looking at 4 percent capital. And I think there are some rules coming or some suggested rules coming that are going to raise that. What is that going to be coming to?

Mr. GUPTA. It is going to be coming to 7 to 8 percent.

Chairman LUETKEMEYER. Eight percent.

Mr. GUPTA. Yes.

Chairman LUETKEMEYER. So why is the private market going to have to go to 8 percent and the Federal Government can be at .4 of 1 percent?

Mr. GUPTA. I think this is definitely one of the discrepancies in the housing finance system right now; every sector of mortgage finance actually has higher capital right now than they did before this cycle. Whether you are talking about banks, mortgage servicers, mortgage insurance companies, every single sector actually has increased capital requirements in the last 6 years, except for FHA.

Chairman LUETKEMEYER. Okay. One of the things we talked about the other day with the Secretary was to ask him what his past due percentage was of his portfolio. He couldn't answer the question. Can you tell me what your past due percentage of portfolio is?

Mr. GUPTA. For general it is 5 percent—90 days.

Chairman LUETKEMEYER. Five percent. So theirs was—the 90 days-plus, the high delinquency, was 7 percent.

Mr. GUPTA. Yes.

Chairman LUETKEMEYER. And they have .4 of a percent. And they are asking you with 5 percent total past due to go to 8 percent?

Mr. GUPTA. Yes.

Chairman LUETKEMEYER. That is a head scratcher, isn't it?

Mr. GUPTA. Yes. Absolutely.

Chairman LUETKEMEYER. Okay. With that, I will end my questioning and go to the ranking member, the gentleman from Missouri, my good friend Mr. Cleaver.

Mr. CLEAVER. Thank you, Mr. Chairman.

Mr. Gupta, do you believe that the lowering of interest rates propels the awarding of bad loans?

Mr. GUPTA. Just the reduction in premium rates?

Mr. CLEAVER. Yes.

Mr. GUPTA. The premium reduction by itself doesn't propel promotion of bad loans. The guidelines itself could propel bad loans. Right now, FHA guidelines go all the way to 3 percent downpayment, down to 580 FICO. Credit agencies that issue this FICO typically will say that FICOs below 630 approximately are subprime prime FICOs. So layering that type of FICO with a low downpayment does stack risk factors against the loan and increases the probability of default.

Mr. CLEAVER. Yes. I would just like to remind everyone that the VA does zero percent, and they have the lowest foreclosure rate, which I think should be at least taken into consideration during this discussion.

But one of the things that I think is troublesome, at least for me, is that I am not sure if there is a concern about FHA having an unfair advantage in terms of business over the private sector, or is there just a general concern for the taxpayers? Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. My primary concern is the taxpayer. The government shouldn't be in the business of competing with the private sector. It sets up programs for social goals. And the assistance to low- and moderate-income individuals to have housing is an important social goal. It should look to achieve the goal and no more.

Mr. CLEAVER. So do you think that we have encouraged competition between FHA and the private sector? Is that what has just happened?

Mr. HOLTZ-EAKIN. What I think has just happened is that the FHA has exposed the taxpayers to unnecessary risks by lowering its premium. That is my primary concern. It hasn't, in my view, taken the right steps to restore the capital adequacy. And it has, in the process of lowering premiums, attracted a riskier portfolio.

Mr. CLEAVER. When the bubble burst in 2008 and the recovery began, the only car in the garage was FHA. The private sector left. So why would we want to do anything that would make potential homeowners more vulnerable, to prevent them from being able to buy a home? If the private sector left—and I don't blame you for the private sector leaving. I am a capitalist. You are in the business of making money. But the problem is, who takes care of the people who are being left behind because the credit has been tightened?

Mr. ROSSI. Actually if I could, Mr. Gupta actually said a little earlier that private mortgage insurance actually wound up paying claims of, what, $55 billion or $51 billion; $44 billion from the GSEs. So from that standpoint, they actually didn't retreat fully from the market, and, in fact, were there to pay claims during one of the worst periods that we have actually ever faced.

Mr. CLEAVER. Let me ask Ms. Gordon.

Ms. GORDON. It is hard to know where to start. But there were also quite a lot of claims PMI did not pay. And, in fact, several private mortgage insurance companies went out of business. There were many disputed claims. There were many claims that were eventually paid, but not at the time they were initally due. So I think you have to look at that to get the full picture.

But I don't want to focus on the PMI. I think the PMI companies are a very important part of the system. I am glad to see them coming back to strength. And I would like to see the pricing of the GSEs change so we could have more robust low downpayment lending going on over there, too.

But the fact is when the rest of the system failed, FHA was there to prevent a real liquidity crisis in this market. And when you look across the sectors at the bailout numbers, the amount of money we spent to bail out the banks, to bail out AIG, and the amount that we spent to bail out the GSEs, those were huge, huge figures; whereas ultimately, FHA required an incredibly small draw very briefly for 1 year. It is actually incredible how cheaply the taxpayer was able to save the housing market. It turns out FHA was a better value than, frankly, anyone had ever really thought it would be.

Mr. CLEAVER. Thank you.

Chairman LUETKEMEYER. Thank you, Mr. Cleaver.

With that, we go to the vice chairman of the subcommittee, the gentleman from Georgia, Mr. Westmoreland.

Mr. WESTMORELAND. Thank you. And I thank the panel for being here.

Ms. Gordon, you wrote in an article about one way that FHA could get rid of some of these loans, I guess, and the fact that they could sell them in bulk?

Ms. GORDON. Yes. They are doing that.

Mr. WESTMORELAND. Okay. And in that article, you mentioned that there are 2 million homeowners who are behind on their mortgages and headed to foreclosure, I think is what you said. And there are another 10 million homeowners who are underwater on their mortgages. How many of those are FHA-insured?

Ms. GORDON. I don't have the exact number of underwater FHA borrowers with me here. I could get that to you.

Mr. WESTMORELAND. Okay.

Ms. GORDON. But it is—I think you will find that the places where homeowners are underwater right now are very concentrated geographically. There has been a geographically uneven bounceback in home prices. So if you live in Arizona or California or some places like that, your home values have gone way back up. If you live in the Midwest, you might be in a different situation.

Mr. WESTMORELAND. I understand.

Now, when you sell these FHA-guaranteed mortgages en bloc, I guess, to investors—I think you mentioned that there were about 100,000 at the time that you wrote the article that had been sold. How does that relieve the FHA? Does that cost the FHA money? Do they have to discount these loans?

Ms. GORDON. It actually ends up saving the FHA a bunch of money. Because what is happening is most of these loans are in that shadow place between the homeowner not paying but the foreclosure not being done, in many cases because the servicer just doesn't think it is worth it or hasn't gotten around to it or whatever.

So what FHA is able to do is to sell these loans before they devalue completely. Before the houses become vacant and become part of neighborhood blight, you want to sell them and get them into the hands of somebody who is actually going to do something about them. So, that is a really good idea.

You also save yourself the carrying cost if that loan does go through to foreclosure and goes into FHA's Real Estate Owned (REO) portfolio. That is going to cost FHA money. So this is a short-circuiting of that. And because there is a lot of demand for nonperforming mortgages right now, there is a market for it, the price that FHA has been able to get on these bulk sales has been surprisingly good.

Mr. WESTMORELAND. And so these people who buy these loans on bulk sale, do you know how they treat the homeowners after they have purchased a loan?

Ms. GORDON. That is what we are trying to get more information about. FHA released a small amount of data last summer. We are hoping that they will release more, and more robust data. We have noticed that in the pools that have neighborhood stabilization outcomes required, a lot of the homeowners seem to be re-performing, meaning they are paying their loans again; whereas on the pools that don't have that requirement, it looks like a lot of these things are getting resold to other investors.

Mr. WESTMORELAND. So these private investors that are buying these loans—let's say the loan is $100,000, the loan balance is $100,000. What would an investor typically pay for that loan?

Ms. GORDON. Maybe somewhere between $60,000 and $70,000.

Mr. WESTMORELAND. Between $60,000 and $70,000, okay. And then, do they reduce the loan amount for the homeowner, the person who—

Ms. GORDON. That is what we don't know yet. That is what we are looking for more information about. Theoretically, they now have much more latitude to do that.

Mr. WESTMORELAND. So, you are just clearing your books. You are just trying to save the FHA money, and not really concentrating on what happens to the homeowners?

Ms. GORDON. No, actually, we are very interested in seeing principal reduction on these loans. And the FHA can't do that, which is one of the reasons that we would like to see these things get into the hands of either responsible investors or, even better, nonprofits or people partnered with mission-based nonprofits in order to make sure these loans are restructured properly.

Mr. WESTMORELAND. Okay. Good. The loan amount is $100,000, and you sell it for $70,000. Now, that is a $30,000 gap. Do you have to pay that $30,000 to the person who had the original mortgage?

Ms. GORDON. The claims get paid in full by FHA.

Mr. WESTMORELAND. That is what I am talking about. So out of these $100,000, if it got reduced 30 percent, that is money the FHA had to pay out—

Ms. GORDON. It is money the FHA had to pay out. And what they are doing it is comparing it with the amount they would have to pay out if this didn't happen. And believe it or not, it is actually smaller.

Mr. WESTMORELAND. I find that amazing, but—

Ms. GORDON. Yes. Some of these homes cost a great deal of money to just keep on and on and on, maybe have them vacant, have them sit in REO portfolios. That is a big waste of taxpayer money. I think it is really important to get these homes back to productive use. And it is really a good opportunity to leverage the private sector in this goal.

Mr. WESTMORELAND. Just one comment: You talk about saving the taxpayer money. The taxpayers are actually paying the difference in that loan balance.

Ms. GORDON. The difference is actually negative because of what they are saving on the back end.

Mr. WESTMORELAND. Okay. Thank you. I yield back.

Chairman LUETKEMEYER. Thank you.

Next is the gentlelady from New York, Ms. Velazquez, for 5 minutes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Ms. Gordon, while FHA's move to reduce insurance premiums will help first-time and minority homebuyers, there has been little discussion about FHA's multifamily business, which helps support the development and preservation of affordable rental housing. And in places like New York and Boston, we are facing a shortage of affordable rental housing.

How has FHA's multifamily portfolio performed in recent years, and can FHA do more to support affordable rental housing?

Ms. GORDON. So first, thank you for mentioning rental housing. We are having a genuine rental housing crisis in this country right now, where for the first time since we have been tracking it, more than half of all renters pay more than 30 percent of their gross income for rent. Anybody who has tried to rent in D.C. knows about this. So it is very important that FHA and the other HUD programs that support affordable housing production and especially preservation of aging stock continue in place.

The portfolios—the multifamily portfolios across-the-board have been doing well. And I will tell you that I am not an expert on multifamily. I didn't come here today with an agenda for what FHA should do. But it is extremely important to continue to fund the production and preservation of rental housing, or this crisis is going to become even worse.

Ms. VELAZQUEZ. Thank you.

Mr. Rossi, you have said that FHA's dual missions to provide access to affordable credit and to protect the MMI fund are often at odds with each other. However, many argue that the recent premium rust will, in fact, address both missions.

Isn't the right pricing of FHA's insurance an integral piece of ensuring that FHA's market share is large enough to provide for the recapitalization of the MMI fund?

Mr. ROSSI. Actually—and this is to my testimony—I am not sure that the actuary report, even we know whether or not we have actuarially fair pricing today, even before the 50 basis point reduction. That is part of what I am discussing here.

And so from that standpoint, we have to step back and focus more, I think, on the pricing as we see it today and make sure that is all right before we actually move further into deciding whether to expand or whatnot in terms of market share.

Ms. VELAZQUEZ. What is your take on that, Ms. Gordon?

Ms. GORDON. I don't think that FHA is taking this action based on just a market share projection. It is really that at this point, they had hiked the premiums up so much that they had really sort of overshot with the credit quality remaining really, really high.

I do think it is important to remember about this whole actuarial report—and I am neither an actuary nor an accountant. But this actuarial report and the number that they come up with for that capital ratio, this is a very conservative approach. This assumes that if FHA were to shut its doors today, does it have enough money to pay every claim for the next 30 years? I know that if we applied that test to my family balance sheet, I would be in big trouble. So, it is an extremely conservative approach.

And so, again, while I can't get into the details of exactly how the actuary does their work, I think it is important to remember that right now these books of business are so clean that they are throwing off these record profits and will certainly be continuing to shore up the fund.

Ms. VELAZQUEZ. Thank you.

Mr. Gupta, you described in your testimony how FHA and private mortgage insurers can and should serve as complementary forces with FHA focusing on underserved markets that the private sector may not be suited to reach.

Mr. GUPTA. Yes.

Ms. VELAZQUEZ. While the U.S. Mortgage Insurers trade group, which you Chair, has expressed concern with a recent FHA premium reduction, saying that private insurance has the capacity to expand access to mortgage credit, how can this position be reconciled with your testimony that many FHA borrowers are not good candidates for this type of product?

Mr. GUPTA. That is exactly the point in my testimony, Congresswoman. If we think about FHA and private mortgage insurance serving complementary roles, that is exactly what I mean. Private mortgage insurance, as I stated in my testimony, still offers 3 percent downpayment loans all the way down to 620 FICO. Once we start going below 620 FICO, from an underwriting guidelines perspective, it is difficult for a private company to actually price loans and put borrowers in homes who are going to be in those homes long term.

Second, from a pricing perspective in competing with FHA, once we go below 620 FICO it is not possible for private MI companies to compete with FHA in that space, given the FHA pricing. So we believe that we have the right complementary roles when it comes to low-credit borrowers. Of our challenges, when FHA reduces price—and we are talking about 680 FICO and 760 FICO, the chart we included in Appendix C of my testimony—you can see that after this price reduction, FHA becomes very competitive—

Ms. VELAZQUEZ. So you are telling me that at that score, lower than 620, they should pay more?

Mr. GUPTA. Based on—for a private MI company, absolutely. We price a risk based on risk-based pricing, because we have to generate a return for our investors.

Ms. VELAZQUEZ. Ms. Gordon?

Ms. GORDON. And the FHA does not risk-base price, which is one of the key differences between what FHA does and what the GSEs do right now. And they do it because they have difficult policy objective.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. I yield back.

Chairman LUETKEMEYER. Thank you.

With that, we will go to the gentleman from New Mexico, Mr. Pearce.

Mr. PEARCE. Thank you, Mr. Chairman. And I thank each one of you for being here today.

Mr. Rossi had made comments about the model that was used to get the predictions. And those seem fairly compelling to me.

Mr. Holtz-Eakin, are you familiar with that model? Do you have the same concerns?

Mr. HOLTZ-EAKIN. I am not intimately familiar—

Mr. PEARCE. It is not your thing.

Ms. Gordon, did you have an opinion on his comments on the model that was used and the complexity and the unpredictability and kind of the weakness of it?

Ms. GORDON. Like I said, I am not an expert on the modeling. But I do know that because the number they are calculating is so conservative, there is some room for differences.

Mr. PEARCE. Okay. At the end of the day, if I am trying to sort through who would be accurate and who is not accurate, I generally think if it were a stock on the stock market, would it sell? If you were given the parameter that there would be no more government bailouts—in other words, Ms. Gordon makes her case very strongly that it is okay, it is operating fine. But I wonder if it were on the stock market, and you were able to buy into that, would you buy into it, Mr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. I would not.

Mr. PEARCE. Mr. Gupta?

Mr. GUPTA. No. And in fact, let me—

Mr. PEARCE. Ms. Gordon, would you put in 30 percent of your personal wealth?

Ms. GORDON. If it had been on the stock market, the housing market really would have collapsed after the financial crisis. I don't think you can—

Mr. PEARCE. No, no. I am just talking about FHA—

Ms. GORDON. I don't think you can compare a public agency—

Mr. PEARCE. We are talking about a model that—and is it true or is it not true that it is in bankruptcy, or that it is very stressed? You make the compelling point that it is not. And I am just asking, would you invest in it?

Ms. GORDON. I think it is yes. I think it is very strongly—

Mr. PEARCE. Okay. You would invest in it then.

Mr. Rossi?

Mr. ROSSI. I believe that we have an extraordinary amount of model risk in the actuarial model. And that is—

Mr. PEARCE. So you wouldn't probably invest in it?

Mr. ROSSI. No.

Mr. PEARCE. One of the comments that was made, I think by Ms. Gordon, was that the FHA was there to prevent a real liquidity crisis.

Mr. Holtz-Eakin, would you comment on that perspective again? It sounded credible, but I would like a little bit more historical knowledge than I have.

Mr. HOLTZ-EAKIN. Certainly. A well-capitalized FHA is—

Mr. PEARCE. No. The comment was that in the 2008 crash, that they were there to provide liquidity when nobody else was there.

Mr. HOLTZ-EAKIN. Yes. I think they did play an important role—

Mr. PEARCE. Okay.

Mr. HOLTZ-EAKIN. —in the crisis. There is no doubt about it.

Mr. PEARCE. Okay. Would we have gotten into the problem if the GSEs—in 2008, would we have gotten into that problem if the GSEs had not moderated, had not changed their underwriting standards? I will just go down the line again.

Mr. HOLTZ-EAKIN. Congressman, I think there was a deterioration in underwriting standards at the GSEs. The FHA, as well. They had zero percent down policies. Those were all—

Mr. PEARCE. Sure. In other words—

Mr. HOLTZ-EAKIN. —bad decisions.

Mr. PEARCE. Ms. Gordon pointed out all the things, the kinds of loans that caused the problems. But if GSEs had not been buying those loans, they would have dried up at the source. Isn't that more or less correct?

Mr. HOLTZ-EAKIN. The GSEs contributed to the housing crisis.

Mr. PEARCE. Mr. Gupta?

Mr. GUPTA. Let me actually add two points to that. I agree with that. I frankly think the GSEs pulled back too far in 2008 and 2009. And when we talk about private capital backing away from the market, in 2008 the private mortgage industry insured $200 billion of mortgages in the United States, in 2009 the private mortgage industry insured $76 billion of mortgages, and in 2010 the private mortgage industry $55 billion of mortgages. So I think the statement that private capital completely backed away might apply to private label securities. But we were still there to serve the market.

Mr. PEARCE. Back to the original question: Ms. Gordon, if the GSEs had not been buying those loans that you were critical of—and you have the right to be critical of them—would the problem have persisted, and would it have grown the way it did?

Ms. GORDON. I think the fact that the GSEs were buying those loans, the securities, definitely contributed to the problem. Although there was lots and lots of cash around the globe contributing to that problem.

I also think in the last couple of years right before the crisis, the GSEs contributed to the problem by buying those loans in what some people call the front door. They were buying some alt-A and subprime loans they shouldn't have been buying. And they were chasing market share. They were responding to the demands of private shareholders.

And I think the GSEs had some very misaligned incentives there, where they had responsibilities to private shareholders but also had this sort of implicit but everybody knew—

Mr. PEARCE. Yes. The top officers were paying themselves very well too; right?

Ms. GORDON. —right. And now we are hearing a lot of calls—

Mr. PEARCE. —based on the cooking of books.

Mr. Rossi, I need to get you in before the light turns red here.

Mr. ROSSI. Sure. Actually, I would say that this goes back to the point that I made earlier, which is that we have a considerable amount of overlap between FHA and the GSE market these days for which we are talking about today. And so there certainly was a deterioration in what we call the credit box by the GSEs, as well as most market participants out there at the time.

Mr. PEARCE. Okay. Thank you, Mr. Chairman. I yield back.

Chairman LUETKEMEYER. Thank you, Mr. Pearce.

And with that, we have the gentleman from Massachusetts, Mr. Capuano, for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman. And I thank the witnesses for being here.

I want to be clear that I am not an actuary, either. None of my colleagues here are actuaries. But we all play one on TV. So we pretend to know all these things, but we don't. And I just want to tell you that Mr. Kildee just asked a serious question that I thought—but I am not going to ask the question. He might when it is his turn. Would any of you invest in the Department of Homeland Security today? I would think if you do, good luck to you, because I wouldn't. But I want to get to my issues.

Honestly, this is the 85th hearing—I think that is an official count—that we have had on the FHA in the last year. It is always the same. The concerns are legitimate. The differences are statistical in they are not objective; they are subjective. What should society be doing? How much should we be risking? Good questions. Serious questions.

At the same time, since we started these hearings, the MMI fund has stabilized. Not a single penny of taxpayer dollars has been used. The only reason it was accessed is because a law said it must be accessed. On top of that, private capital has come back into the market. And the FHA's share has been reduced—the numbers I have are from $1.8 million in 2009 to $786,000 last year. We are heading in the right direction by anybody's measure. We are not arguing basics here. We are arguing—again, not arguing. We are discussing details and where the margins are, all good, all important.

But to be perfectly honest, it is not worth an 85th, 86th, 87th, and 88th hearing, unless there is a change in that direction. We are heading in the right direction by everyone's estimate. Is that wrong? Does anybody disagree that we are heading in the right direction? I think the answer is, you agree.

Mr. GUPTA. Congressman, just one comment in terms of Mr. Holtz-Eakin's testimony. One thing that changes with this price increase is that trajectory and market share has a potential to change.

Mr. CAPUANO. Everything has a potential to change. I could lose an election. You could lose your job. Anything can change. But at the moment, based on recent history, things are heading in the right direction. So I think—not that these direction discussions aren't important—we should have hearings on other things.

So all that being said, I want to talk about a couple of things that are still—Mr. Rossi, really, I want to start with you. For a couple of years now, I have been arguing—and it turns out apparently you have also been arguing—that the receivership of Fannie and Freddie has now overstayed its need and necessity and should be ended and we should stop this ridiculous sweep of profits. Now you might want to—then we can argue about Fannie and Freddie fees and what to do with the money. Different issue.

Right now, it is being used as a piggy bank by the Federal Government for no particular purpose. It doesn't help the housing market. It doesn't help anybody in private industry that I know of.

Mr. Rossi, did I read your stuff right, that you think the receivership should be ended because it is no longer necessary?

Mr. ROSSI. Yes. And the context for that, Congressman, was the following. It was as much out of exasperation when—I have been following this too; it almost feels like Groundhog Day at times—where we have had proposals to reform the GSEs at various times. And for whatever reasons, it hasn't come to fruition.

So my point of writing that piece or pieces was just to acknowledge that maybe we could take a more pragmatic approach, look at HERA and decide whether an administrative solution was the answer.

Mr. CAPUANO. And HERA, for all intents and purposes for those who don't know, are those reverse mortgages that every movie star in the world apparently wants to sell me on TV; is that right?

Mr. ROSSI. HERA is the legislation that, among other things, created the Federal Housing Finance Agency, as well as established, if you will, the way in which the GSEs—

Mr. CAPUANO. Dr. Rossi, I would love to talk to you more about this. Because this is—honestly, I feel like I am a voice crying in the wilderness here. Here I am, Mr. Pro-market, apparently. I guess I am not as liberal as some people think.

Ms. Gordon, I want to talk to you about something else, something I talked to the Secretary about a little while ago. These batch sales, these bulk sales of foreclosed homes. I, for one, think that we are not getting the top dollar we should be getting. I think you would get much more money if you broke them up and sold them in very small batches or even individually, which might be—the overhead might be a little too much individually. But certainly in small batches.

And on top of that, I think you get a better bang for your buck relative to community needs. Each community is different. And if you sold them in small batches, you would give an opportunity for people who actually know the local market to bid on them and to fix them up and put—have a much higher incentive to fix them up and help the neighborhood. Do you think that is wrong? Do you think we should continue these massive bulk sales to investors, as opposed to more community-based sales?

Ms. GORDON. We agree it would be much better if these could be sold to nonprofit organizations or—in many cases, you see private investors partner with nonprofits, which sometimes can be the best of both worlds. Small pools and geographically-concentrated pools really help that. You can't do all of it that way.

Mr. CAPUANO. Right.

Ms. GORDON. Because, of course, some of the stock is just—it is not going to work out that way. We have a whole country to cover. But that would be a good idea. It would also be a very good idea to require all investors, whether they are or nonprofits or private investors, to make sure that they give the homeowner a chance to re-perform, or avoid foreclosure before taking them through foreclosure. And that requirement isn't in place for all of those loans right now.

Mr. CAPUANO. I appreciate that. I will see you all at the 86th hearing.

Chairman LUETKEMEYER. Thank you, Mr. Capuano, for those insightful remarks.

With that, we go to the gentleman from Virginia, Mr. Hurt.

Mr. HURT. Thank you, Mr. Chairman. Thank you for holding this hearing. And I appreciates our witnesses being here today.

I guess one of the things that I think is most important for Congress to tackle, considering we are 7 years after the crisis, is housing finance reform. We have to deal with that. And it is remarkable that 7 years after the fact, we still haven't dealt with it. With that said, the Administration released a report in January of 2011. And I would like to ask you, Ms. Gordon, and then maybe have Dr. Holtaz-Eakin follow up.

But there was a report in 2011 entitled, "Reforming America's Housing Finance Market: A Report to Congress." I don't know if you are familiar with that. But in that report, the Administration reports several things: "FHA has also implemented important changes and reforms over the last 2 years, including strengthening underwriting standards, improving processes and operations, and raising premiums to improve its financial condition."

It went on the say that as Fannie Mae and Freddie Mac's presence in the market shrinks, the Administration will coordinate program changes at FHA to ensure that the private market, not FHA, picks up that new market share. Finally, as we begin to pursue increased pricing for guarantees at Fannie Mae and Freddie Mac, we will also increase the price of FHA mortgage insurance.

Now, I guess my question is, in 2011, 3 years afterwards, was it a mistake for the Administration to take those actions and have those objectives? And if it was a mistake, I would like to hear your thoughts on that. If it was not a mistake, then why are we doing—why is the Administration's position changing?

Ms. GORDON. First of all, I don't think the Administration's position has changed at all. FHA increased its premiums very significantly, and they still remain very elevated. That was a very small adjustment the other day to only one out of the various components of the premium structure. So I respect the conversations, but it was a little bit of a nonissue in some ways.

What is important is that we still have not had this conversation about housing finance reform in the past—we have started to have it. Congress has started to have it. But it keeps petering out because it is one thing to say that private capital should come in, but if you talk to people in that sector, they don't have any certainty yet about what this system is going to look like. They have no idea about what the future of the government guarantee is. And they are just going to do other things with their money until we actually figure out a national housing policy here.

Mr. HURT. So you don't think that the Administration has changed its policy or is getting away from these three points that it made 3 years after the crisis?

Ms. GORDON. No, I don't think it is. The group that FHA is going after right now is the group that private capital doesn't want. Mr. Gupta has explained that he doesn't want borrowers under a 620 credit score. The purely private sector only wants the very most pristine ones.

Mr. HURT. Okay. My time is limited. Let Dr. Holtz-Eakin respond. And then if Mr. Gupta would also like to also respond.

Mr. HOLTZ-EAKIN. The reduction in premium is not exclusively for those under 620. It is a reduction in premium for everyone. So it is not like this is a targeted policy on an under—an unserved group. And it is, however modest or large you want to characterize it, a change in their position from a couple of years ago.

I think the important thing here is that everyone focuses on the countercyclical role of the FHA, which is real; but that is an automatic thing. And this isn't countercyclical. This is a discretionary procyclical cut in the premiums. And that is an unwise thing to do.

Mr. HURT. Mr. Gupta?

Mr. GUPTA. I will illustrate three things. First thing, a 40 percent reduction in premium is not an immaterial reduction. And in private industry, if we reduced our premium by 40 percent, we would not be generating a return for our investors.

Second thing, private capital is ready and is there today to expand its market share. Every MI company has been raising capital through equity, through debt. Our parent company raised $400 million in December of 2013 and downstreamed all that money into our mortgage insurance unit. So in terms of being there and being ready to insure more borrowers, private capital is there.

Third thing, when we are talking about borrowers below 620, that is where private market insurance does not have guidelines currently. To Dr. Holtz-Eakin's point: above 620, down to 3 percent downpayment, 50 percent debt-to-income ratio. These guidelines are available in the marketplace and have been available in the marketplace over the last 3 years.

Mr. HURT. Thank you. Mr. Rossi, do you—it looks like I have—

Mr. ROSSI. Yes. One other thing I would say is with the advent of the GSEs now, with their new credit policy around allowing 97 percent LTV loans, they are pushing into that market even before what they had.

The other thing that I would say too is that I believe the latest annual report for FHA actually cites the fact that they still are looking to have market share—or private capital, rather, reenter into the market. So, just to kind of state that.

Mr. HURT. Thank you. I yield back my time.

Chairman LUETKEMEYER. I thank the gentleman from Virginia.

With that, we have the distinguished gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman. And I thank the ranking member and the witnesses, as well.

Let's move to Dr. Holtz-Eakin. Sir, I believe I heard you indicate, comparing FHA to another circumstance, that you can't cut taxes and raise revenue. I think that is what I heard you say. Is that what you said, that you can't cut taxes—

Mr. HOLTZ-EAKIN. I pointed out that this is exactly the same argument people make, and most people don't believe it.

Mr. GREEN. So it is your position that if you cut taxes, you are probably not going to raise revenue?

Mr. HOLTZ-EAKIN. Yes. I am on record and that is—I did studies on that at the Congressional Budget Office in 2003.

Mr. GREEN. All right. Would it surprise you to know that a good many of your friends on the other side would differ with you on that basic premise of cutting taxes and raising revenue?

Mr. HOLTZ-EAKIN. The next time everyone agrees with me will be the first.

Mr. GREEN. I believe you. But the first won't happen today.

Mr. HOLTZ-EAKIN. I am not waiting.

Mr. GREEN. I will allow my colleagues on the other side to entertain further debates.

Let's move on to Ms. Gordon. Ms. Gordon, you mentioned the HAWK program. And you wanted to give some examples of things that we could do to strengthen FHA, and you mentioned HAWK. You also in your testimony give an indication that there was a part of this that was not properly implemented. Would you care to elaborate on HAWK and that portion that wasn't implemented and how that can be of benefit to FHA?

Ms. GORDON. HAWK stands with Homeowners Armed With Knowledge. I had nothing to do with naming it. And this was a program that would have helped support getting more housing counseling, possibly both pre-purchase and post-purchase. The studies that have been done out there—and we now have some very good studies—demonstrate both for pre-purchase counseling and post-purchase counseling after a homeowner is in trouble, the counseling can significantly increase the chance of success of the homeowner.

It remains a mystery to me why the entire mortgage industry is not focused like a laser on trying to get housing counseling to every person who is going to buy a house. This is an incredibly complex transaction involving more money than most consumers will ever spend on anything else in their lifetime, and we expect them to just go out into the marketplace to do this themselves. That just doesn't make any sense when for really just a very small amount of money, we could significantly increase the success rates of mortgages and do a better job of working with servicers when mortgages get into trouble for some reason, due to a life event.

So it is very unclear to me why—and this program never got implemented. But Congress, in the spending bill just basically eliminated it, essentially. I don't think there was much debate or discussion over this. And so I think it is really important to go back to the drawing board and try to figure out how we can make sure that high-quality housing counseling is available for every purchaser who wishes to use it.

Mr. GREEN. Mr. Rossi, would you concur?

Mr. ROSSI. I would. I would actually go further and say that Radian, in fact, has a partnership in place with a diverse segment to train, teach, and coach folks to be able to get into mortgages.

Mr. GREEN. Mr. Gupta?

Mr. GUPTA. I would concur that housing counseling should be there. But whether housing counseling actually makes borrowers perform better or not, we have not seen that in our experience. But we also conduct housing counseling for free for borrowers.

Mr. GREEN. Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. I have not studied the issue.

Mr. GREEN. Okay. Would you care to the respond to the indication that the empirical evidence is not there, Ms. Gordon?

Ms. GORDON. For a long time, there hadn't been a lot of studies of pre-purchase counseling. Because a lot of the studies that happened, happened post-crisis, when most of the activity was in the loan modification space. But there has been a study—it is cited in my testimony—that does indicate pre-purchase counseling does improve outcomes. And I think the best kind of counseling at all is not just pre-purchase counseling, but is counseling that continues to be available after the person is already in the home.

Mr. GREEN. I want to thank all of you for your testimony. And my assumption is—and if I am incorrect, kindly extend a hand into the air—that you would all like to see FHA remain a part of the housing finance system, that no one on this panel believes that we should not have an FHA. Is that a fair statement?

Perhaps I should revise my statement. If you concur with me—we will do that this as we do it in court—raise your hand, please, if you concur. Thank you very much.

I yield back, Mr. Chairman.

Chairman LUETKEMEYER. Thank you, Mr. Green.

With that, we will go to the gentleman from Florida, Mr. Ross.

Mr. ROSS. Thank you, Mr. Chairman.

Every time the government gets in the business of business, it draws some concerns. Because if the markets could not sustain the business, then what makes us think that government can sustain it any better? And I think that is where we are today. We have seen a housing crisis, which has been precipitated by a housing policy that encouraged people to buy houses that they could not afford. And we, as a government, set them up for failure.

And today, I heard Mr. Gupta say, and I want to confirm this, that since 2007, you have not only paid every claim that you have had, but you also continue to raise capital at a fairly significant rate?

Mr. GUPTA. Yes. Genworth has paid $6.2 billion in claims since 2007.

Mr. ROSS. And so while there appears to be a supply side of the product, the capital, and there clearly is, Ms. Gordon, I believe a demand for this capital, as there is a desire for housing. Then what gets in the way?

Ms. GORDON. There are a few things that get in the way right now because the market does not work perfectly. For one—

Mr. ROSS. And does the market not work perfectly because some of the prices that are involved in the market are competitively low and set by government?

For example, private mortgage insurance. Now, we have reduced the premiums on private mortgage insurance, as my chairman pointed out, in an effort to try to make it more affordable, but also to increase the amount that is going to go into the MMIF. In order to do that, again using the example of the chairman, if you have a trillion dollars in liability, and you have to come up with 66 percent more, and you are now up to $1.6 trillion in liability because you have had to increase your volume, makes me feel that the only scenario is that you have to drink yourself sober in order for this to be successful. And I don't think that is realistic or possible.

And to that end, I would suggest that we might want to start a 12-step process. Because I know the government has involved itself in a business transaction, and we just can't go cold turkey. We have to wean ourselves. Because what I am hearing today is that the capital is out there. The buyers are out there. But we are prohibiting them. And if we allow them, some of them, we are setting them up for failure.

So Dr. Rossi, I would just submit to you, is there not a possibility that we can take a hybrid method by which we can accommodate the demand in the market and the supply from both the private sector and the government to create a hybrid product that would allow for private capital into the market, qualification of mortgagors, and wean the government's exposure off time?

Mr. ROSSI. Absolutely. And let's not forget, a lot of what we are talking about here is an overlap and sort of a lack of mission clarity of what FHA is really supposed to do, which—

Mr. ROSS. We don't have a mission, do we?

Mr. ROSSI. Not that—

Mr. ROSS. It has been suggested that it is for first-time homebuyers who can't afford a home and allows them to enter into the market. Because a house is not a savings item. It is a consumption item.

Mr. ROSSI. Right.

Mr. ROSS. And we want to make sure that they are using it for the right purposes by giving them that opportunity. So shouldn't we statutorily gave a mission statement to the FHA as a first step?

Mr. ROSSI. I believe that would help quite a lot, to clarify exactly where one ends and one begins. I think right now we have this fusion, if you will, between both of these. And we are having this conversation in part because of that.

Mr. ROSS. And shouldn't we cede some of that liability that FHA has to the private sector that is waiting on the sidelines, the same way a reinsurance company would be there to take some of the risk away from us in the Terrorism Risk Insurance Act (TRIA) or any other government insurance program that we have.

Mr. ROSSI. HUD's annual report has actually said that.

Mr. ROSS. Wouldn't you agree, though, that reducing—and I am going to ask you this, Dr. Holtz-Eakin—the premium has actuarially no basis in fact?

Mr. HOLTZ-EAKIN. I hope that it is clear that is what I believe. This is a mistake.

Mr. ROSS. So aren't we then at the crossroads where we must engage the private market, otherwise we are going to relive our failures of 2007 or 2008? Dr. Rossi?

Mr. ROSSI. I would say this—I would think that the private sector does a much better job of pricing that risk of an insurance fund than the Federal Government can do. So from that standpoint alone, as I said in the testimony, we can't—at least in my opinion—be sure that what we have today priced is priced correctly for the type of risk that is in that portfolio.

Mr. ROSS. Pricing that risk and also managing that risk, as well; correct?

Mr. ROSSI. Correct.

Mr. ROSS. Lastly, I will—

Chairman LUETKEMEYER. —30 seconds.

Mr. ROSS. Oh, okay.

Ms. Gordon, there was a report in May 2012 from the George Washington School of Business that indicated that 30 percent of

FHA loans are going to families making 115 percent—115, one-one-five percent—above our average median income.

If the goal of FHA is to serve low- and moderate-income families, what good are we doing trying to serve those who are above that? Shouldn't we change that, or at least identify in the mission that that is not the market we are going after?

Ms. GORDON. I think it is important to distinguish income from wealth. There are some people who have a higher income, but may not have enough wealth from the bank of mom and dad or what have you to put down a very big downpayment. They may need FHA. They may be able to get a loan through the Enterprises. Fannie and Freddie are really serving a very—a high credit score borrower right now—

Mr. ROSS. And they should.

Ms. GORDON. —not the average—well, maybe they should. Maybe they should come down. That depends on what you believe the mix should be between FHA and the GSEs.

But I do think the place to start—and I think I agree with a lot of people on this panel about this—is to look at loan limits. The problem with loan limits is you have to be very careful to take into account the radically different costs of homeownership in different geographies.

Mr. ROSS. And the qualification of the buyer. I yield back.

Chairman LUETKEMEYER. Thank you, Mr. Ross.

We go to the gentleman from Michigan, Mr. Kildee, for 5 minutes.

Mr. KILDEE. Thank you, Mr. Chairman. And I thank the panel. I don't know how many hearings we have had on this, but I don't mind. This is a really important discussion, and it is one that we ought to continue.

Before I have a couple of questions for Ms. Gordon, I want to follow up on a comment Mr. Gupta made and just make sure I understand it.

I took your comment to say that you—regarding the value of counseling, pre-purchase counseling particularly, that you were not aware that it had a significant impact as being an indication, that it is something that you haven't studied?

Mr. GUPTA. We actually have studied it. We offered pre-purchase counseling for many years prior to this cycle as a company and as a industry. For Genworth, in our data—and we insure close to 600,000 loans, so we actually have good delinquency data—we did not see any meaningful difference between borrowers who went through pre-purchase counseling and borrowers who did not go through pre-purchase counseling.

That being said, I am supportive of the fact—we are supportive of the fact that pre-purchase counseling is generally good for the housing market.

Mr. KILDEE. I think I understood what you just said, that it is good for the housing market, but it doesn't make any difference?

Mr. GUPTA. From a performance perspective, it doesn't demand any price discount.

Mr. KILDEE. The reason I ask the question is, first of all, I think the statement might be somewhat incongruous here in Congress.

We had a hearing last year, where I posed the question to some of the country's biggest mortgage lenders. And they indicated it was their experience that made a difference and that when we look at—particularly among those borrowers who are having a difficult time accessing the housing market, that it really does make a difference.

I think it is important that we make it clear that there is data that shows it is a positive thing. In my own personal experience, having worked in the field before I came here, I know that it made a significant difference. So I think I would like to see the research.

And I think one of the questions that it begs is what kind of counseling were these individuals getting? Because the quality of the counseling is a significant factor in determining its outcome. So it might be a distinction. But it might be more attributable to the quality of the counseling that is being received.

If I could turn to Ms. Gordon, we have heard a lot about the premium reduction. Could you just help clarify for us, who benefited? Who benefits from that change?

Ms. GORDON. The people who benefit from those changes the most are the ones who were probably unable to get into homeownership at all before because the costs were too high. This does reduce the costs for families on the low end of FHA, where there isn't this competition. It is absolutely true that the premium reduction does slide the scale over to where if you compare the exact same GSE loan with the exact same FHA loan, it changes the price point at which one versus the other makes sense. That is virtually never from the way that homeowners actually end up in the home.

Lots of homeowners, particularly homeowners of color, tend to be steered to FHA whether or not they can qualify for a less expensive Fannie or Freddie loan. And then, there are many folks who want a Fannie or Freddie loan because they want to avoid the paperwork and what have you with the FHA loans.

So the people who are being helped most here are the ones who weren't going to be able to afford to do it, but were close. And I know it has been said that if somebody is only close to affording homeownership but isn't there yet, they shouldn't have homeownership, but I don't understand that at all. If you are at appropriate debt, and you have appropriate income, you have been underwritten appropriately.

And particularly, in the many geographic areas right now where it is considerably less expensive to own a home with a responsible mortgage than it is to rent, I don't see why as a public policy matter, we would not want to encourage that.

Mr. KILDEE. That is a very good point. And I wonder if you would comment on the distinction that a publically-charged agency has for the positive externalities that it creates. In a purely private side of the market, it is obviously driven by the profitability of the enterprise, and often does not include the positive externalities that come in a community or a neighborhood including access to homeownership in the first place, the stability of neighborhoods, and the effect on equity of others who are not affected by that transaction.

And then there was a discussion earlier about principal reduction. The value of principal reduction in preservation of homeownership is not simply realized by the borrower and the lender, but by people who live in proximity to that property. And I wondered if you could just briefly comment on—

Ms. GORDON. Absolutely. Every foreclosure brings down the values of neighboring properties. If that home is not immediately reoccupied, it raises the risk of blight. It increases cost to fire and police. It reduces the tax base. And having lots of foreclosures in one place—we have seen this happen—can take a neighborhood and start a downward spiral that is very, very hard to reverse.

We should be trying across-the-board, whether it is an FHA or a Fannie or Freddie or a private label loan to not have unnecessary foreclosures. When a home is vacant, on the other hand, it should be foreclosed on quickly—

Mr. KILDEE. Right.

Ms. GORDON. —and rehabbed and reoccupied.

Mr. KILDEE. Thank you very much. I appreciate it all.

Chairman LUETKEMEYER. Thank you, Mr. Kildee. With that, we will go to Mr. Rothfus, from Pennsylvania.

Mr. ROTHFUS. Thank you, Mr. Chairman. And I appreciate the panel being here today.

Dr. Holtz-Eakin, when Secretary Castro was here a couple of weeks ago talking about these issues, I raised an issue that was described in a recent Politico magazine article entitled, "The Real Bank of America." Specifically, the article discussed a September 2013 taxpayer-funded bailout of FHA, going on to state, "in fact the FHA had been receiving silent taxpayer-funded bailouts throughout President Obama's first term; bailouts that went unnoticed because of the odd process the government uses to calculate the budget costs of credit programs."

Separately, a CBO blog post from October 2013 reviewed and explained that FHA's guarantee programs had not produced the estimates FHA anticipated of a $45 billion savings, but rather a cost of $15 billion.

Could you elaborate a bit further on what the cost to taxpayers has been for bailing out the FHA?

Mr. HOLTZ-EAKIN. I don't have the precise number. But for well over a decade now, CBO has been examining the performance of credit guarantees and loans under the Federal Credit Reform Act which, as written, forces the budget process to leave out market risk and, as a result, understates the risk being absorbed by taxpayers, and often leads in the course of watching loans through time to reestimates of the credit loss by the Office of Management Budget.

No one ever notices those. They come out every year. If you look at the credit tables, you will find that, for example, this year the student loan portfolio had a $22 billion reestimate. The FHA has continual reestimates. Those are losses that are not very visible, but they are real.

Mr. ROTHFUS. Dr. Rossi, when I asked Secretary Castro 2 weeks ago whether he could reassure the committee that the FHA would not need another taxpayer bailout, the answer he gave us was no, that he didn't know. However, the Administration and folks on the other side of the aisle have been saying that the $1.7 billion taxpayer bailout did not mean the FHA needed cash to pay claims.

Is the FHA poised to need another bailout in the future?

Mr. ROSSI. This gets exactly to my own testimony about this issue about whether it does or it doesn't. And quite honestly, given sort of where I see the modeling within this actuary model, there is always a possibility that can be the case.

Mr. ROTHFUS. So under what circumstances could you find the need for another bailout?

Mr. ROSSI. Certainly, over the next several years, if we were to find that there was pressure on home prices, that somehow we got a hiccup in the marketplace again, we had a recession, if not a mild recession, even a more severe recession, that could certainly put the numbers into doubt.

Mr. ROTHFUS. Dr. Holtz-Eakin, there have been concerns that the Administration, which controls the FHA, coordinates management and policy decisions with outside advocates that may or may not be equipped to understand the complexities of a trillion dollar portfolio or the risks posed to the U.S. taxpayers.

Do you believe the FHA's policies are influenced by political events and outside groups, as opposed to the business model used by private mortgage insurance companies?

Mr. HOLTZ-EAKIN. Yes, I do. If you look at this premium reduction, it was foreshadowed before the President's State of the Union address. It was then announced in the State of the Union Address. Simultaneously, there were letters of support for it, which miraculously arrived. And the entire thing was done in 9 business days. It is unprecedented.

Mr. ROTHFUS. Do you believe that the FHA should be regulated just like any other financial company?

Mr. HOLTZ-EAKIN. The FHA is not a business. And we shouldn't pretend it is a business. It is a government program to subsidize homeownership for certain people. Unfortunately, we don't know who those certain people are. There is no clear mission statement. And we aren't making transparent the subsidy that we are giving them. And those are the kinds of reforms we need in FHA.

Mr. ROTHFUS. Would it be the kind of enterprise, if it were under the private sector, that might be deemed a significantly important financial institution—

Mr. HOLTZ-EAKIN. Yes.

Mr. ROTHFUS. —because a failure—

Mr. HOLTZ-EAKIN. And it would be in receivership right now.

Mr. ROTHFUS. Dr. Rossi, under Dodd-Frank, FSOC designates significantly important financial institutions, or SIFIs, when a financial institution is regarded as so important to the economy that its failure could lead to a widespread economic crisis.

Should the U.S. Government also review government-owned companies or institutions that could pose a risk to the U.S. economy?

Mr. ROSSI. Absolutely. Given the size of the fund that we are talking about, at $1 trillion-plus, that is significant in its own right for further oversight.

Mr. ROTHFUS. Should the U.S. Government have its own institutions subject to a SIFI destination in order to be watched by more than one Federal department?

Mr. ROSSI. I am not sure we would have to go so far as to have it designated specifically, as in the case of bank or nonbank SIFIs.

But at the same time, I still maintain that it needs much greater focus.

Mr. ROTHFUS. The Administration has stressed that its $46 billion in assets is more than enough to meet any expected claims in 2015 or 2016. Do you believe that $46 billion in assets is enough to protect taxpayers from problems that could be encountered by a trillion dollar portfolio?

Mr. ROSSI. Is that question directed at me?

Mr. ROTHFUS. Yes.

Mr. ROSSI. Okay. If you look at the capital reserve number, I believe the capital reserves are something like $20 billion. And when you look at the present value of cash flows, I think that is where we get to this $5.9 billion.

Based on what I said earlier about changes in home prices, economic conditions, there is a possibility, of course, that it could encounter problems in the future.

Mr. ROTHFUS. I yield back. Thank you.

Chairman LUETKEMEYER. Ms. Moore—

Mr. HOLTZ-EAKIN. I would just like to point out that—

Chairman LUETKEMEYER. Very quickly, please.

Mr. HOLTZ-EAKIN. I just want to point out that when I was at CBO in 2003 and 2004, we did exactly the kind of simulation modeling that Dr. Rossi is talking about for Fannie Mae and Freddie Mac. We calculated there was an implicit guarantee of $20 billion a year provided by the taxpayers. Everyone told us exactly the same thing; we have all these reserves, it will never happen. We know what happened.

Chairman LUETKEMEYER. Thank you.

Next, we go to Ms. Moore, from Wisconsin, for 5 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman.

Chairman LUETKEMEYER. Let me just interrupt, Ms. Moore. You got here a little late. What we are going to do, since we don't have the clocks around, is when you get down to the 30-second mark, I will give a little rap so you know you have have 30 seconds left to ask questions and get answers. Okay?

Ms. MOORE. Thank you so much.

Chairman LUETKEMEYER. Okay.

Ms. MOORE. Thank you, Mr. Chairman and Mr. Ranking Member. And to our esteemed panel here, thank you so much for appearing.

My question is for Mr. Gupta. You mentioned in your written testimony that lowering the mortgage insurance premiums at FHA has a couple of immediate consequences.

I support the policy of FHA lowering its charges for mortgage insurance. But I am wondering, could you expound on how you think this pricing impacts the upcoming rule-making process for private mortgage insurance eligibility requirements?

And since you put yourself in—since you are in the first-risk position, how will this structure, the PMIER rules, better put the private capital in first-risk position, while retaining that strong counterparty creditworthiness?

Mr. GUPTA. Absolutely. Thank you for the question, Congresswoman.

The first thing, with this FHA premium reduction, FHA actually will take longer to actually get to their 2 percent minimum required statutory capital. Right now, they are at .41 percent. And their estimate was to get there by 2015 or 2016. And by some estimates out there it, it could delayed by 1 to 2 years.

FHA already has a lower capital regime than private mortgage industry, which is currently at a 4 percent statutory requirement. And we expect that 4 percent statutory requirement to go up to 7 to 8 percent.

So in terms of private mortgage industry being well-positioned in the marketplace to play a bigger role, this move reverses that. This move challenges the possibility of private mortgage insurance and private capital playing a bigger role than it plays right now.

As far as PMIERs are concerned, GSE eligibility guidelines, as GSE eligibility guidelines get finalized, the perception of the industry having strong capital and being a strong counterparty significantly improves across all sectors. And the possibility of either GSEs or the FHA doing more risk-shares with private mortgage industry actually also gets higher.

I would say that is a very important element or initiative that we should focus on. Because as we are thinking about FHA's pricing, doing a risk-share with the private mortgage industry actually lets you validate that pricing because you get a market price from a private entity. So as we talk about sufficiency of price, that will be a very good initiative.

Ms. MOORE. And it won't have a chilling impact on borrowers being able to come in and qualify for the loans?

Mr. GUPTA. Absolutely not. Private mortgage insurance industry rates are very competitive. Before I came in, we talked about 3 percent downpayment, 620 FICO, all the way to 50 percent debt-to-income ratios. So, the guidelines are expansive, and the rates are extremely competitive, and I don't see any challenges with that.

Ms. MOORE. Ms. Gordon, you seem like you are just champing at the bit to say something.

Ms. GORDON. I just think—I have nothing against the possibility of FHA trying risk-sharing, in theory. And it has been tried before and hasn't worked particularly well.

I think it is important to recognize a few things. First of all, when you bring two parties in who have some interest in the outcome and disposition of that loan, it can be very difficult to get them all on the same page. That has been a problem with loan modifications for some people.

One of the things that the new FHFA rules will do is have private mortgage insurers essentially delegate their responsibility to the GSE servicers so that they can handle things more efficiently and effectively for borrowers.

And so any time you do any kind of risk-sharing, it is important to recognize the different incentives of the parties and the different missions of the parties and make sure that you are structuring any program to account for those different incentives and different structures properly. Actually, for most of these loans, if you have any downpayment at all, the borrower is in the first-loss position, then the mortgage insurer.

So, I am just adding a word of caution in terms of these different structures. What I do want to say is that right now, if Fannie and Freddie were to change their policies with respect to the very steep risk-based pricing in which they have been engaged, I think you would see a lot more borrowers able to go to Fannie and Freddie, and then PMI would be able to insure those loans.

Ms. MOORE. Do you agree, Mr. Gupta?

Mr. GUPTA. Yes. We do—I do agree.

Ms. MOORE. Thank you for your indulgence, Mr. Chairman.

Chairman LUETKEMEYER. Thank you. Thank you, Ms. Moore.

With that, we go to the gentleman from California, Mr. Royce, for 5 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

I am increasingly concerned here. And I would ask this of Mr. Gupta and Mr. Holtz-Eakin. The government actions here at both the GSEs and the FHA could, over the long term, fuel another bubble. And when I say "fuel another bubble," I remember talking to the Fed in 2004, 2005, about their worries; right? And I had legislation in 2004 and 2005 in order to regulate the GSEs for systemic risk. Unfortunately, we were unable to get that through.

Now, you look at requirements with a low 3 percent downpayment requirements where you have seller concessions that add up to about 6 percent; right?

Mr. GUPTA. Yes.

Mr. ROYCE. You look at the FICO scores now as low as 580. So we know from the lead-up to the financial crisis that it is all gravy as long as prices continue to go up. If we could pass a law that mandates that housing prices continue to go up, there is no problem.

But if you are not going to allow a system of checks and balances in the economic system but instead, you are going to step in with a Government-Sponsored Enterprise here, and with all the moral hazard that implies, and you are going to drive a policy where we have the former FHA Commissioner saying that FHA's financial condition is not where it should be yet in terms of wholesale rollback of the premiums.

Here is the concern: Have we once again created a situation where individuals with no equity in their homes end up leveraged to an almost personal Ponzi scheme with the consequences to them afterwards of losing their homes? The consequences to the taxpayers of dealing with another bailout. The consequences to the financial system of dealing with the shock. The consequences to the neighborhoods of going through what we went through in 2007, 2008.

What are your thoughts on the end game here, Mr. Gupta, with the level of government involvement that we have here and the moral hazard that would imply?

Mr. GUPTA. Thank you for the question, Congressman.

Going back to Dr. Rossi's statement, I do think that there is a risk here that we are putting borrowers in homes who actually may not be able to withstand that financial stress, any financial stress on the economy. If you look at FHA's own actuarial report, there are scenarios in that actuarial report which actually point to negative capital if the financial environment—if the housing and economic environment does not turn out to be the expected environment.

So there is a scenario here where these prices are not sufficient, and a lack of an actual way of getting to these pricing, that is the risk it creates. I think from a financial system perspective, there is also a cost to it. For comparison, as a private MI company, if we were running at one-fifth of our required statutory capital, first thing, we would be in run-off; we would not be writing any business. Second thing, if we were writing any business, we would never be allowed to actually lower our prices by 40 percent, because part of that capital is what actually replenishes your capital to get to the statutory minimums.

So yes, there is the risk of that financial burden, as well as borrower burden.

Mr. ROYCE. Now, I would like to go to Dr. Holtz-Eakin, because the other aspect of this that is confusing to me, is that the Administration says on the one hand, the President's budget said that we needed to require more private capital in the housing system. That makes sense based upon what we have been through. And this comes on the heels of cutting FHA premiums by 40 percent. Is there a contradiction here?

Mr. HOLTZ-EAKIN. I believe so, yes. And to the earlier part of your question, I agree with what Mr. Gupta said. And if you think back to the early part of the lead-in to the housing bubble, we saw then-HUD Secretary Andrew Cuomo cut premiums. We saw diminishment in downpayments. We saw the kinds of mortgages that Ms. Gordon described. And we saw it worldwide.

We now have FHA, Fannie Mae, and Freddie Mac, all agencies of the Federal Government for all practical purposes, making exactly the kinds of discretionary policy moves we saw in the lead-in. The only thing that is missing are the worldwide aspects and the exotic mortgages. But I think that while it is not quantitatively the same phenomenon, it is qualitatively going in that direction. I am concerned.

Mr. ROYCE. Is my time expired?

Chairman LUETKEMEYER. You have 30 seconds.

Mr. ROYCE. Any other—

Ms. GORDON. I think it is important to say that FHA actually was the only entity that didn't get into the business of the loans without underwriting and the loans with all the predatory features. If we are—everybody here raised their hand before in answer to the question, do we think FHA has an important role.

Mr. ROYCE. That is true. We all agree with that.

Ms. GORDON. Okay. But if FHA is to remain strong enough we can't say—

Mr. ROYCE. Maybe the role is so important that everything should be FHA and there should be no private capital. Clearly, what we are debating here is where is the role of private capital to make certain there is an offset to the risk? Because clearly, based upon the government coming in with GSEs in the past, you are not going to adequate price risk in the marketplace. You are going to put a penny in the fusebox, and you are going to short-circuit the whole system in terms of supply and demand in this. And the consequence of it can be a huge bubble in the marketplace.

Ms. GORDON. Sure. What happened—

Mr. ROYCE. That is what we don't want to see happen.

Ms. GORDON. What happened during the crisis was actually the private sector wildly—

Mr. ROYCE. It was because of the moral hazard put in there by the government. We tried to regulate against that.

Chairman LUETKEMEYER. Thank you, Mr. Royce.

Next up, we have the gentleman from Texas, Mr. Williams.

Mr. WILLIAMS. Thank you, Mr. Chairman.

What this country needs, I believe, is a mortgage finance system that is not only sustainable, but reduces taxpayer risk while giving hardworking Americans the opportunity to buy homes they can actually afford to keep.

Yet, this is not what the FHA has become. With over a trillion dollars worth of backed mortgages, which represents half of the insurance market, and only $46 trillion in assets, FHA has put the taxpayer at risk. With such a large portfolio, FHA's recent actions indicated it could potentially put another 250,000 new homeowners on the books by reducing annual premiums.

By adding riskier buyers and lowering premiums, I believe FHA is operating outside of its historic mission, which is supposed to operate with a high degree of public and fiscal responsibility. Like many, I believe that the answer to fixing these problems is in the private sector.

Now, with that said, let me just go over some numbers really quick that concern me. We have heard in testimony that $670 billion in additional growth in the portfolio is to just get us back to present income levels.

Now, we also heard from Secretary Castro that he feels like there is probably between the new portfolio and the existing portfolio $12 billion in total loss on these portfolios. He also said that $8 billion is estimated income at the new level of fees that we are talking about. When you put math to that, we are $4 billion short.

My question to you, Ms. Gordon, would be how do we cover that and where does it come from?

Ms. GORDON. So FHA—those numbers aside, FHA is making money right now and—

Mr. WILLIAMS. But those are the numbers. And we have a loss.

Ms. GORDON. —FHA is likely to continue making money.

I do not know exactly what those numbers refer to enough for me to comment on FHA's balance sheet. What I can comment on about FHA's balance sheet is that the current books of business are very strong, are making a lot of money, and they are positioned to do that in the future.

The books of business that we are losing the most money over time are running off and will be losing less money. The policies that allowed—in fact, one of the policies that allowed the most losses was the seller-funded downpayment program, a policy that FHA actually tried to end, but Congress didn't want them to end. Had it not been for that policy, FHA would never have been in the red at all.

So I think we have the look at the policies and the direction of where things are going, which is a very positive direction. At the same time, the HUD Secretary has an obligation to make sure that the FHA is serving homeowners.

Mr. WILLIAMS. All right. Possibly you can get back with us on the best way—

Ms. GORDON. I can get back with you on the numbers.

Mr. WILLIAMS. If you would do that, I would appreciate it.

Mr. Gupta, do you have an answer to that? You are a private sector man, as am I.

Mr. GUPTA. Yes, well—

Mr. WILLIAMS. There is a $4 billion shortfall.

Mr. GUPTA. Yes. So the math is very simple. When you lower your premiums by 40 percent, you actually need a volume increase of something larger than 40 percent to get back to revenue neutral itself. And I do not believe that FHA thinks about getting their market share higher by 40 percent. So it would be a net negative.

Mr. WILLIAMS. I agree with you.

The other question I have for you, Ms. Gordon, is that I think it was back in September of 2013, that FHA drew $1.7 billion out of the Treasury to continue to do business. That money belongs to taxpayers.

Ms. GORDON. Actually, it wasn't to continue to do business. It was because there is—

Mr. WILLIAMS. To shore up your balance sheet.

Ms. GORDON. There is a certain amount that is—there are different accounts in different parts of the government. And you are required to have—

Mr. WILLIAMS. You agree that it was the taxpayers' money?

Ms. GORDON. All of this money is the taxpayers' money.

Mr. WILLIAMS. Okay. With that being said—

Ms. GORDON. It was not any more the taxpayers' money coming from FHA's account than from Treasury's account.

Mr. WILLIAMS. Ms. Gordon, with that being said, should the FHA pay that back to the taxpayers?

Ms. GORDON. I believe the FHA already has.

Mr. WILLIAMS. I asked Secretary Castro that, and he couldn't give me an answer.

Ms. GORDON. This is all—

Mr. WILLIAMS. So you agree with me—

Ms. GORDON. These are accounting mechanisms. Just the same as someone will tell you that technically, the GSEs have not paid back the Treasury yet. Of course, they have paid back the Treasury.

Mr. WILLIAMS. You agree with me then that the taxpayers should get their money back at some point in time?

Ms. GORDON. I think the taxpayers already have.

Mr. WILLIAMS. We disagree on that.

I yield back, Mr. Chairman.

Chairman LUETKEMEYER. Thank you.

With that, the gentleman from Tennessee, Mr. Barr.

Mr. BARR. Thank you, Mr. Chairman. Just to correct the record, Kentucky. And the Wildcat fans would be offended to be associated with the Volunteers. But thank you, Mr. Chairman. And thank you to our witnesses.

I have only been in Washington for a little over 2 years, but it never ceases to amaze me that Washington doesn't seem to be able to learn the lessons of history, and recent history, at that. So here we have Fannie Mae and Freddie Mac jumping back into offering 30-year loans for borrowers who can only afford a 3 percent downpayment. These loans are exempt from the requirements that another Federal agency, the Consumer Financial Protection Bureau, says are required under the Qualified Mortgage Rule, which is supposed to prevent a recurrence of loose lending.

And now the FHA has reduced its premiums in a move designed to expand its market share, but which is certainly going to hurt its capitalization. In lowering these premiums, the FHA is once again luring people who are unprepared for the obligations of homeownership into risky loans they are unable to repay. And this risk goes right to the taxpayers.

So Ms. Gordon, let me start with you. In an August 2012 White Paper that you coauthored for The Center for American Progress—you will recall that it is entitled, "It's Time to Talk About Housing"— you decried the practice of loan originators who steered borrowers into risky subprime loans, even when they qualified for better loans, citing predatory pricing gimmicks that both encouraged borrowers to borrow far more than they could manage and required the borrower to refinance every couple of years. You noted that such loans tended to default at significantly higher rates than conventional mortgages.

So now let's look at what the FHA is doing: Employing pricing gimmicks, exceedingly low downpayments, low credit scores, inadequate up-front pricing, and high maximum dollar value loan limits. And the FHA loan default rate is nearly 150 percent higher than prime loans. And I have read that FHA loans are defaulting one out of eight, right?

So why aren't the FHA's practices squarely within the subprime practices that you decried in that 2012 White Paper?

Ms. GORDON. Actually, first of all, let me correct the record. FHA is not exempt from the Dodd-Frank mortgage rules. That is a very important point. The Dodd-Frank mortgage rules put a floor under this market that did not exist before. Had the Dodd-Frank mortgage rules been in place in 1995, we would not have had the crisis that we had. FHA has to abide by the ability-to-repay requirements. FHA has a Qualified Mortgage safe harbor that is extremely similar to CFPB—

Mr. BARR. If I could jump in. It is similar. Let me jump in right there. Because I have asked this question of Secretary Castro, and he acknowledges it. It is not the QM rule. It is a different rule. It is a different underwriting standard than what the Bureau says is a Qualified Mortgage. So, it is a double standard.

Ms. GORDON. It is almost identical. The reason it is different is because the statute tells FHA to do its own QM, and specifically says the CFPB is doing a QM for the private market.

Mr. BARR. Let me jump in there and let's follow on this theme of a double standard. Okay? Because it is very troubling to me that Washington continues to live by one set of rules while they impose an entirely different set of rules on the private sector.

And to Mr. Gupta, I want to just ask you, so the capital reserve requirement by law for the private mortgage insurance industry is 4 percent, and could go up to 8 percent?

Mr. GUPTA. Yes.

Mr. BARR. And the rule for the FHA is 2 percent. Which they can't even comply with, by the way.

Mr. GUPTA. Yes.

Mr. BARR. Totally different rules apply to the government than apply to you. And for the rules that apply to the government, which are different than the rules that apply to the private sector, the government is in noncompliance.

Mr. GUPTA. Yes. You are correct, Congressman.

Mr. BARR. Even though they got a bailout. Did you get a bailout, a $1.7 billion taxpayer bailout in the private mortgage industry?

Mr. GUPTA. Absolutely not.

Mr. BARR. This is a double standard. The American people are tired of Washington living by one set of rules and the private sector and the American people living under another set of rules.

Let me quickly go to Dr. Rossi. I was interested in your testimony speaking of applying the same set of rules to the government. Your recommendation that there be Qualified Mortgage rule harmonization, can you amplify that testimony?

Mr. ROSSI. Yes, I can. With regard to FHA, for example, today it is my understanding that they allow lenders, as long as there are compensating factors, to actually underwrite the loans. So they are relying on the lenders to do the review here for DTIs, debt-to-income ratios, above the bright line 43 percent test that is in QM for everybody else.

Mr. BARR. So you would disagree with Ms. Gordon that—

Mr. ROSSI. There is a different set of rules.

Ms. GORDON. Actually, right now, almost all loans go through either the GSEs or the FHA. And the GSEs also permit loans over 43 percent DTI if there are compensating factors. And they also leave the underwriting up to the lenders. So frankly, it is exactly the same across the vast majority of the book right now.

And I should also add, since you quoted me and I would like to correct the record, that the kinds of loans I was talking about in that August 2012 paper are precisely the kinds of loans FHA has never done. FHA has always required underwriting, it does not have pricing gimmicks, and it does not have steep rate resets.

Mr. BARR. Mr. Gupta, I think you wanted to comment on that?

Mr. GUPTA. I would agree with Dr. Rossi that for FHA, greater than 43 DTI is permitted, because that is the rule they make. And for private label securities or for portfolio loans, a bank would actually not be permitted to actually use that rule.

So FHA does have an advantage in terms of creating their own definition of QM. That also applies to the definition of safe harbor applied on—so FHA actually calculates that safe harbor coverage differently than private label securities.

Mr. BARR. Thank you. I yield back.

Chairman LUETKEMEYER. Thank you, Mr. Barr. My apologies to you. As contrition for my sins, I did allow you a significant amount of time over your 30 seconds.

Thank you. Well done.

It looks like the last gentleman today to ask questions is the gentleman from Illinois, Mr. Dold.

Mr. DOLD. Thank you, Mr. Chairman. And I want to thank our witnesses for coming. And I also want to thank my colleague from Kentucky for his questions. I am going to kind of dovetail off of some of those.

I think as we look at FHA, there is no question that we all want FHA to be healthy and that we certainly think that they provide a service. We have a requirement in terms of capitalization that FHA needs to be at 2 percent. That is not a recommendation, is it? Does anybody think that is a recommendation? I think that is written actually as part of the law. Can I just ask each and every one of you, in your opinion, is FHA abiding by the law?

Mr. HOLTZ-EAKIN. No.

Mr. GUPTA. No.

Ms. GORDON. The statute has a number of provisions—

Mr. DOLD. Wow. I am just—okay. A number of provisions?

Ms. GORDON. It has a number of provisions. And they are also required to balance the mission of providing homeownership while they are rebuilding to the capital ratio.

Mr. DOLD. So is that a yes or a no, they are not abiding by the law?

Ms. GORDON. I believe they are following the law right now.

Mr. DOLD. Okay. How about you, Dr. Rossi?

Mr. ROSSI. No.

Mr. DOLD. Let me go to you, Mr. Gupta. We asked Secretary Castro about this. And again, I am in the private sector. Or was, certainly. And we want FHA to succeed. There is a reason why, again, your threshold is 4 percent, potentially going up higher, correct?

Mr. GUPTA. Yes.

Mr. DOLD. What happens if you are under the 4 percent?

Mr. GUPTA. We go into remediation immediately. So regulators actually have to make sure that we are on the path—

Mr. DOLD. But what happens if you just say no, we are trying, we are going to to get there soon.

Mr. GUPTA. You go into run-off.

Mr. DOLD. What?

Mr. GUPTA. Going out of business.

Mr. DOLD. So they take and they actually—they put you out of business?

Mr. GUPTA. Yes. You go into run-off.

Mr. DOLD. The FHA hasn't been at their 2 percent threshold in a long time, anywhere close to it. When we asked the Secretary, he basically said, well, we are working on it.

Now FHA has a different mission, of which we say is kind of a little foggy in terms and we would like to have some more highlighting in terms of what that mission is. But what we know is that FHA is going down a path where they have a 2 percent threshold. And yet, they don't factor risk. They are not supposed to. They don't do that. Which would—I would argue, Dr. Holtz-Eakin, would that make it a riskier proposition by not factoring the risk?

Mr. HOLTZ-EAKIN. Absolutely.

Mr. DOLD. Okay. And so I guess my take is in the private sector, if you don't hit the threshold, the regulators come in and take you over. And yet, you are assessing market risk; is that correct?

Mr. GUPTA. Yes.

Mr. DOLD. So for me I just, again, share this frustration that certainly some on the panel recognize, that we want FHA to be healthy. We want them to be able to be at these capital standards. And yet, they kind of look at us cross-eyed when we say, you are not even meeting the 2 percent threshold. Which, ultimately, is putting the taxpayers at risk. And we recognize that they have a different mission.

What do we have to do, do you think? What would your recommendation be for us to get FHA to where it needs to be, according to the letter of the law? Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. Two things: first, in the narrow, you don't lower premiums when you need to build capital.

The bigger problem is the mission. Ms. Gordon said, when asked who benefits in this, "It is the people who were just short, and now they can buy a home." That is true now with the lower premiums. So you could lower premiums again and help some more people who were just short, and there would still be some people who were just short. And in the process, you would worsen the taxpayer's exposure while you are helping these people who were just short.

The question is, when do you stop? What is the mission of FHA? You can always justify a premium reduction by that logic. So you have to find a mission and then stick to it.

Mr. DOLD. One of the things I would also like to talk about, Ms. Gordon, because when you talk about the HAWK program—actually one I agree with—I have worked with one of my colleagues on the other side of the aisle about saying, what can we do in terms of a program, a pilot program to say, does the counseling actually help, does it actually reduce that risk in terms of the mortgage market? And I would still like to see a study done.

Because, Mr. Gupta, if we could prove that with counseling it would actually lower the rates, would that impact how you assess market risk?

Mr. GUPTA. Absolutely.

Ms. GORDON. Actually, footnote 53 in my testimony will show you cites to a study from the Philadelphia Fed and from Freddie Mac that demonstrate that.

Mr. DOLD. Okay. Last question for you, Ms. Gordon. And I appreciate that.

You said that you thought FHA was abiding by the law with regard to its 2 percent threshold. They are lower than that now. Do you think that percentage should be lowered? Or should there be any percentage at all?

Ms. GORDON. No. I think we should get back to the 2 percent. I think that is very important. And I think they need to get back there responsibly. Just as if my family had a rainy day fund, and say I lost my job, and we blew through our rainy day fund. I would like to rebuild that rainy day fund. At the same time, I have to continue to buy groceries and put gas in the car.

So I think it is very important for FHA to continue moving in that direction. They are moving in that direction. They did not wholesale roll back premiums. And if they were to stop moving in that direction, I think they have to reevaluate again.

Mr. DOLD. Thank you all very much. My time has expired.

Chairman LUETKEMEYER. I thank the gentleman from Illinois.

We were hoping Mrs. Beatty would get here. She was supposed to be on her way. But we have no idea if she is going to be here in 2 minutes or 20 minutes from now. So, let's proceed.

I just want to summarize here. I think there is a general consensus that FHA has a place in housing finance. And the consensus of the group seems to be that the guarantee fees are endangering the viability of that agency by reducing those. Also, that there is plenty of room in the private market to be able to come in. They are ready, capable, and they have proved that they can be a viable alternative and part of the marketplace. And I think all of these things are important.

We certainly appreciate your testimony today. It was knowledgeable and insightful. And thank you for bearing with us and going through all the inclement weather. I know it wasn't easy to get here today. So I appreciate your efforts.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And with that, the hearing is adjourned. Thank you.

[Whereupon, at 12:02 p.m., the hearing was adjourned.]

APPENDIX

February 26, 2015

Center for American Progress

Julia Gordon
Director, Housing and Consumer Finance
Center for American Progress

The Future of Housing in America: Oversight of the Federal Housing Administration, Part II
Testimony before the U.S. House of Representatives Committee on Financial Services
Subcommittee on Housing and Insurance

February 26, 2015

Good morning Chairman Luetkemeyer, Ranking Member Cleaver, and members of the subcommittee. My name is Julia Gordon, and I direct the housing and consumer finance team at the Center for American Progress, a nonpartisan think tank dedicated to improving the lives of Americans through progressive ideas and action. Thank you so much for convening this hearing on the Federal Housing Administration, or FHA. I greatly appreciate the opportunity to testify today about the FHA and its importance to America's families, the housing recovery, and the broader economy.

Introduction

Research and our lived experience confirm the link between housing and opportunity in this country, from the many benefits of homeownership for families and communities to the central role of the housing economy on economic vitality. A healthy housing market, when coupled with appropriate protections to ensure responsible and sustainable lending, offers opportunities for young people to begin building wealth through homeownership, for growing families to access good schools and high-opportunity neighborhoods, and for older people to choose whether to age in place or seek a smaller or more supportive environment.

Yet at present, the nation's housing recovery is neither strong nor equitably distributed. Not only has the national mortgage market shrunk significantly, but many communities, especially communities of color, lag far behind non-Hispanic white communities, and hard-hit neighborhoods continue to suffer the ongoing effects of multiple foreclosures, negative equity, vacant homes, and blight. We have turned back the clock nearly 20 years on homeownership rates, and rental costs are soaring relative to incomes.[1]

Consequently, the Federal Housing Administration is now more important to the country than ever. Established in 1934 to promote long-term stability in the U.S. housing market after the foreclosure crisis that occurred during the Great Depression, FHA reinvented housing finance by demonstrating that long-term, fixed-rate mortgages could help middle-class families build long-term economic security even through uncertain economic times and that lenders could extend credit to a broad population on fair terms with good economic results.[2] In the 80 years since, FHA has helped more than 40 million creditworthy families realize the benefits of homeownership.[3]

Since that time, FHA's role has evolved. First, the agency focuses on facilitating homeownership for creditworthy borrowers who would otherwise have difficulty putting together a 20 percent down payment, such as first-time homebuyers and homebuyers of color. To accomplish this goal, FHA doesn't lend directly to homebuyers. Rather, it insures loans made by private lenders that meet strict size guidelines and underwriting standards. To fund this insurance, the agency charges both upfront and annual fees, the cost of which the borrowers cover themselves.

Second, FHA keeps mortgage credit flowing during business cycle downturns when private investors retreat. This so-called countercyclical role proved to be of critical importance in preventing a much more severe collapse of the housing market after the 2008 financial crisis. While playing this role severely strained the agency's finances, a combination of strong management, critical policy changes, and overall improvement in the housing market—in part due to FHA lending—has put the agency on track to fully replenish its capital reserve fund within the next two years.

Going forward, FHA should continue to assisting first-time and low-wealth borrowers, provide stability in the mortgage market, and maintain the insurance fund's financial integrity. While Congress should provide necessary oversight to ensure FHA is pursuing this mission in a responsible fashion, FHA needs the authority and latitude to make certain business judgments within the congressionally mandated framework.

In this testimony, I will discuss the work of today's FHA, the state of FHA's finances, and several improvements that FHA can make to further its mission of supporting homeownership while strengthening its financial position.

I. FHA Today: Providing America's families with safe and sustainable loans and supporting the housing market through the business cycle

FHA's most recent books of business will likely perform better than any books of business in the agency's history, yet FHA's critics continue to insist that FHA engages in risky, predatory lending. A review of the agency's policies and processes demonstrates that today's FHA supports loans are safe, sustainable, and appropriate for the communities they serve.

A. Providing America's families with safe and sustainable loans

Even in the run-up to the crisis, FHA *never* insured the type of dangerous, poorly underwritten loans that triggered the financial crisis. The predatory loans securitized by Wall Street during the boom were hybrid adjustable rate mortgages, interest-only loans, and so-called "pick-a-pay" loans that featured extremely low teaser rates with steep resets, prepayment penalties that extended beyond the loan reset dates, and numerous other confusing features. The sudden increases in monthly payments required borrowers to refinance repeatedly, generating impressive fees for brokers but stripping borrower equity. Additionally, mortgage brokers got paid more to put borrowers in loans at higher rates than they qualified for, to lock borrowers into those loans with prepayment penalties, and to encourage borrowers to choose products that required little or no income documentation.[4]

Contrast those toxic loans to FHA loans, the vast majority of which are "plain vanilla," long-term, fixed-rate mortgages with no resets and no prepayment penalties; unlike most private mortgages, most FHA mortgages are even assumable. The agency has always required full underwriting and documentation: a key reason that FHA lost so much market share to private label securitization was that brokers and real estate agents wanted to avoid the paperwork involved in processing an FHA loan.[5]

That is not to say that FHA has never engaged in discriminatory and risky practices. Early in its history, FHA engaged in "redlining," which meant refusing to insure loans made in communities of color, which denied African Americans and other minorities the opportunity to build the wealth that helped so many white families enter America's growing middle class after World War II.[6] The Fair Housing Act of 1968 prohibited this practice, and after continued struggles with discriminatory pricing and fraud, including shoddy underwriting and inflated appraisals,[7] FHA has now become not just a reliable source of credit for communities of color, but in many ways, the only reliable source.

Another risky practice was instituted during the housing boom, when FHA offered a program of seller-funded down payment assistance in which nonprofit groups funded primarily by home builders provided borrowers with down payment assistance. Unfortunately, the incentives in this program were not properly aligned, leading some builders to inflate the prices on these loans, which resulted in many borrowers being underwater on their mortgages from day one. This program performed extremely poorly during the crisis; in fact, it contributed so heavily to FHA losses that had these loans not been made, FHA would have nearly reached its 2 percent capital ratio by now.[8] For years, FHA wanted to end the seller-funded down payment assistance program, but Congress prevented them from doing so until 2008, and the change did not take effect until the second fiscal quarter of 2009.

Another excessively risky program was the FHA reverse mortgage program, enabled by a change to the law signed by President Ronald Reagan in 1987.[9] This program offered a product that was potentially helpful for some seniors, but it carried far too few consumer protections for something so confusing and potentially damaging, and seniors using the program became a target for those selling fraudulent or inappropriate financial products.

However, since 2008, FHA has eliminated the seller-funded down payment program, significantly overhauled the reverse mortgage program, and instituted numerous other changes to protect taxpayers, strengthen FHA's risk management, and ensure borrowers are put into high-quality mortgages in which they will succeed.

Most importantly, to protect consumers and reduce risk-layering, FHA now specifies a minimum credit score, requires a much higher down payment for borrowers with credit scores below 580, and requires manual underwriting for any borrower with a credit score under 620 and a debt-to-income ratio of more than 43 percent, a practice that results in safer loans because borrowers must demonstrate compensating factors.

Contrary to some statements made in this committee recently,[10] FHA loans all must conform to the Dodd-Frank Act's mortgage rules that require lenders to assess a borrower's ability to repay before making a mortgage. Dodd-Frank also required FHA to develop its own qualified mortgage, or QM, standard, which is very similar to the standard established by the Consumer Financial Protection Bureau for the private market, and the agency finalized that standard in December 2013.[11] Loans made under all of these policies will have an extremely high chance of success.

Also, to rebuild the fund and to align risk with pricing, FHA has increased its annual mortgage insurance premium significantly; even after the recent decrease announced in January by President Barack Obama, the annual fee is still 50 percent more than it was in 2008.[12] It has also raised its upfront insurance fee by 75 percent and required that premiums be paid for the life of their loan rather than being cancellable when the loan reaches a 78 percent loan-to-value ratio.[13]

Other important changes include the following:

- FHA has improved its loss mitigation processes, which simultaneously provide troubled borrowers with expanded opportunities to avoid foreclosure and also result in lower losses for the fund.
- FHA has also increased the number of individual pre-foreclosure sales—or short sales—and is selling thousands more properties pre-foreclosure through bulk auctions, a program known as the Distressed Asset Stabilization Program, or DASP. Selling loans before foreclosure allows FHA to avoid taking possession of the property, saving significant money on maintenance and marketing costs for houses that it took possession of after foreclosure. FHA estimates that the DASP alone has reduced losses by an estimated $3 billion over the past two years.[14] These policy changes, alongside improving home prices, has meant that recoveries on insurance claims have increased 68 percent since their lowest level.[15]
- FHA is improving its Quality Assurance Taxonomy, which provides improved definitions of loan manufactured defects. This project aims to improve the quality of loans that FHA

insures while also providing lenders with more certainty about what loans FHA will force them to buy back due to their errors or fraud. FHA is also working to increase clarity for lenders by consolidating its disparate pieces of guidance into a single source.

- HUD has also heightened its enforcement of FHA lenders, terminating relationships with lenders who violate its requirements and generating millions of dollars in penalties from lenders who violate HUD rules.[16]
- FHA has made important changes to its reverse mortgage program, limiting both the upfront and overall equity that is available to borrowers, requiring that these lenders assess a borrower's ability to pay taxes, insurance, and other property expenses or escrow for these funds for the borrower, and requiring customers to obtain housing counseling before obtaining a reverse mortgage.
- FHA has created an Office of Risk Management, imposed higher minimum net-worth requirements for lenders to mitigate counterparty risk, and updated appraisal standards.

Despite its safe and sustainable loans and greatly improved business processes, critics continue to attack FHA's basic business model. Some critics simply oppose low down payment lending, mistakenly believing that low down payments were what led to the housing crisis. Yet properly underwritten, low down payment mortgages with long-term, fixed interest rates have performed well even throughout the Great Recession.[17] The predatory mortgages that brought down Wall Street's house of cards sometimes included low down payments, but they also layered multiple risks—such as exploding interest rates, exorbitant fees, and steep prepayment penalties—with little or no underwriting. Most of these practices are now prohibited by the Dodd-Frank mortgage rules.

Other critics portray FHA as a destabilizing force in communities, such as the December 2012 American Enterprise Institute report written by Ed Pinto titled "How the FHA Hurts Working-Class Families and Communities."[18] In this report, Pinto presents a correlation between FHA and high foreclosure rates in distressed communities as if to imply that the FHA is responsible for the high foreclosure rate. Yet the concentration of FHA loans and the high rates in these communities are largely a result of the unsustainable private subprime mortgages pushed in these communities during the housing bubble. FHA was one of the only lenders supporting the housing market in these distressed communities at the height of the foreclosure crisis because most private lenders had fled the credit risk of such neighborhoods; in other words, FHA's presence was not a cause but a consequence of the neighborhood's financial distress. Had FHA followed Pinto's ill-supported advice and refrained from lending in distressed neighborhoods, many of the neighborhoods that are now entering a recovery period likely would have been lost for good.

What's more, the report relies on data from the 2009–2010 book years, just months after the government bailed out the nation's major financial institutions, Fannie Mae and Freddie Mac entered conservatorship, credit markets froze, unemployment spiked, and housing prices were in free fall. Additionally, the 2009 book also still includes a sizable chunk of seller-financed down payment assistance loans.

That said, Pinto's report raises important questions that it will be worth continuing to discuss, especially how to encourage the conventional market to lend to qualified borrowers in underserved communities and populations to promote competition and avoid unnecessary concentration of FHA loans.

B. Supporting the housing market through the business cycle

The past two decades have been a time of great volatility and challenge for FHA, and its performance over this period has proven its critical role in America's mortgage market.

Beginning in the 1990s, with the emergence of new mortgage products bundled by Wall Street investment firms into private mortgage-backed securities, the mortgage market underwent a historical shift. The new lending featured products with dangerous loan terms such as steep rate resets, prepayment penalties, and negative amortization, and underwriting ranged from poor to nonexistent.[19] Yet because teaser rates and other pricing gimmicks made these loans appear more attractive and because mortgage brokers needed to do less paperwork and were offered better compensation for pushing these loans,[20] many borrowers who would have qualified for prime conventional or FHA loans ended up in these dangerous subprime loans instead.[21]

As private subprime lending gained market share for low down payment borrowers during this period, FHA's market share plummeted. In 2001, the Federal Housing Administration insured 14 percent of home-purchase loans; by 2006, that number had decreased to less than 4 percent.[22] Some lenders expressed concern about FHA's very survival.[23]

When the bubble fueled by this unsustainable lending finally burst in a flood of delinquencies, defaults, and foreclosures, the housing market teetered on the edge of collapse. The Wall Street firms that had fueled the private label securitization stopped providing capital, banks and thrifts pulled back, and subprime and nontraditional lending essentially came to a halt. Fannie Mae and Freddie Mac were placed under conservatorship when their capital proved inadequate, and they both imposed new fees, including steep risk-based pricing that significantly limited the ability of the mortgage giants to serve any but the most pristine borrowers. Private mortgage insurer, or PMI, activity plummeted,[24] with some PMI companies failing and regulators taking over others.[25] For many lenders and borrowers, FHA was the only place to turn. (see Figures 1 and 2)

Figure 1:

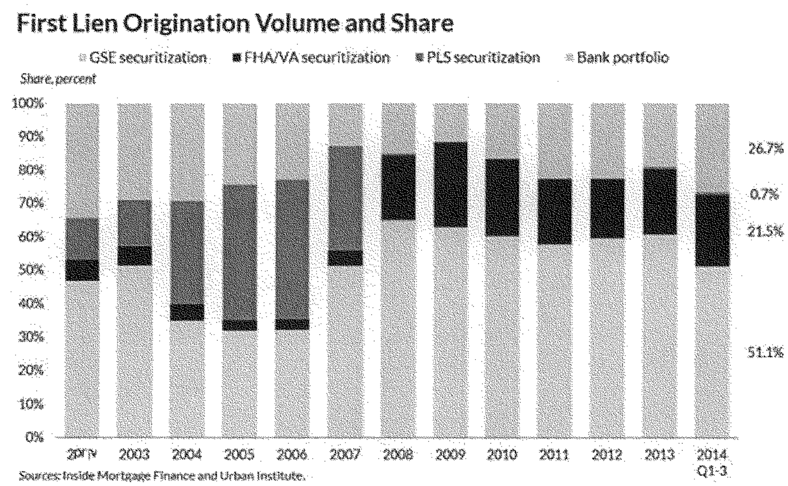
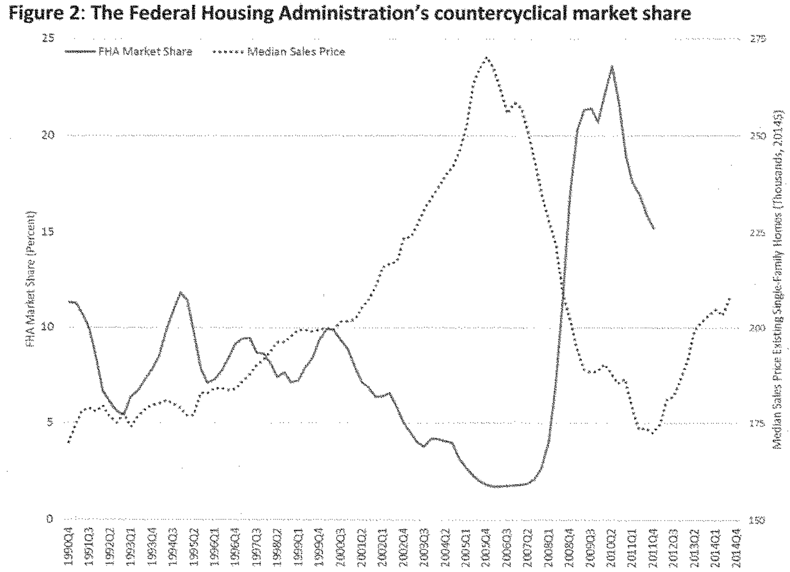


Figure 2: The Federal Housing Administration's countercyclical market share



Four-quarter moving market share. Source: Inside Mortgage Finance; National Association of Realtors®; Moody's Economy.com. Compiled by Kevin Park and Roberto Quercia at the UNC Center for Community Capital.

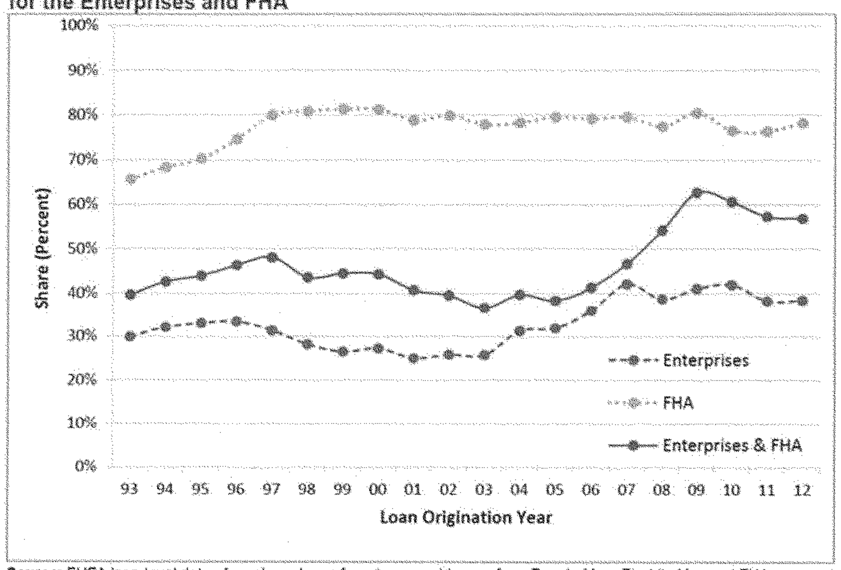
Moody's Analytics estimated that if FHA had not been available to fill this gap, mortgage interest rates would have more than doubled, new housing construction would have plunged by more than 60 percent; new and existing home sales would have dropped by more than one-third; and home prices would have fallen twice as far as they did.[26] The analysis suggests that a second collapse in the housing market could have sent the U.S. economy into a double-dip recession, causing the economy to shed another 3 million jobs and the unemployment rate to rise an additional 1.6 percent.[27] We can only imagine what this additional damage would have meant for losses and taxpayer costs at Fannie Mae and Freddie Mac, as well as other large financial institutions involved in the mortgage market.

Without FHA, the mortgage market would still be in far worse shape than it is. Since stepping into the breach in 2008, FHA has backed more than 5.5 million home-purchase loans and helped another 3.5 million families lower their monthly payments by refinancing.[28]

Equally important is the composition of FHA borrowers. In 2014, 81 percent of FHA endorsements in 2014 were for first-time homebuyers.[29] (see Figure 3)

Figure 3:

Exhibit 3. First-Time Homebuyer Shares of Purchase-Money Loans for the Enterprises and FHA



Source: FHFA loan-level data of purchase loans for primary residences from Fannie Mae, Freddie Mac and FHA.

Moreover, in 2014 more than three-quarters of FHA's endorsements[30] were for home-purchase loans, whereas only half of Fannie Mae and Freddie Mac originations were for home-purchase loans.[31] In 2013, although FHA only constituted about one-fifth of the overall market,[32] it backed *almost half* of the home-purchase mortgages obtained by African Americans and Latino homebuyers.[33]

Even as the economy recovers, first-time homebuyers and other lower-wealth households still cannot access conventional loans, yet their participation remains critical to the health of the mortgage market. Right now, for a conventional home-purchase mortgage, the average FICO score is 752, while for FHA, is it closer to 680—still much tighter than historical norms, but more accessible to the typical household (nationally, the median credit score is 711).[34] Additionally, homeownership rates for young people—ages 25 to 34—are among the lowest in decades[35] at a time when it is most important to have new households entering the market. The Bipartisan Policy Center estimates that Echo Boomers—those born between 1981 and 1995—will drive 75 percent to 80 percent of owner-occupied home acquisition before 2020 as Baby Boomers sell off their homes.[36] Homes are significant reservoirs of wealth for Boomer families, and their retirement security and ability to remain independent may be significantly affected if new households are unable to provide sufficient effective demand for these homes.

II. Current financial condition: Recovering from its crisis role

Today, FHA's Mutual Mortgage Insurance Fund is back in the black, with a value of positive $4.8 billion.[37] The current state of the fund reflects a $21 billion dollar improvement over the past two years. While the agency has not yet rebuilt its capital cushion to the statutory 2 percent level, it is well on its way to doing so while continuing to balance its dual mission of supporting homeownership while maintaining the fund.

FHA's January 2015 announcement in January 2015 that it would reduce its annual premium deserves fuller explanation. Since the crisis, FHA has increased its premiums five times, including increasing both the upfront premium and the annual premium and disallowing the cancellation of the annual premium after the loan-to-value ratio hits 78 percent.[38] This recent reduction applies only to the amount of the annual premium and only partially rolls back the increases made since the crisis. The upfront premium remains unchanged and the annual premium is still in place for the life of the loan.

Even after the premium cut, the Office of Management and Budget, or OMB, projects that new loans in FY 2016 will make a net profit to taxpayers of 3.7 percent on an average FHA loan—and a gross profit to taxpayers of $6.423 billion[39]—and both FHA actuaries and Moody's Analytics have found the premium reduction will not make a very significant difference in the time it takes FHA to reach the 2 percent mark.[40] In short, this is a modest, carefully calibrated action that strikes the proper balance between increasing access to credit and maintaining fiscal prudence.

Chairman Jeb Hensarling's claim that the U.S. Department of Housing and Urban Development, or HUD, is violating the law by reducing its annual premium at a time when the ratio has not yet returned to 2 percent[41] takes the required ratio out of the context of the entire statute. Specifically, when the insurance fund is undercapitalized, the HUD secretary may "propose and implement any adjustments to the insurance premiums" and must consider FHA's capital requirements alongside other "operational goals," including "meeting the needs of homebuyers with low down-payments and first-time homebuyers by providing access to mortgage credit."[42]

As HUD Secretary Julián Castro explained in his recent remarks to this committee, after FHA analyzed the effect of these increases, their data showed that the increases had resulted in FHA collecting about $17 thousand from each borrower to cover projected risk of less than $5 thousand.[43] This massive overcharging was negatively affecting FHA's mortgage volume, and while it is possible that some borrowers may have gone to the conventional market, given how many FHA borrowers cannot access the conventional market, it appeared more likely that otherwise underserved borrowers were simply not accessing the market at all. Additionally, especially as Fannie Mae and Freddie Mac reduce their own down payment requirements, FHA has an obligation to ensure the credit quality of its entire book of business, which means avoiding excessive adverse selection.

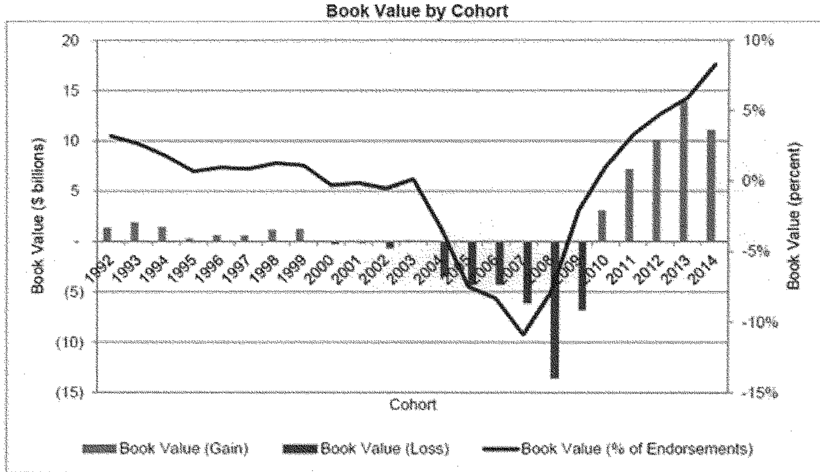
In short, correcting the pricing to meet the homeownership needs of its target market and to ensure the credit quality of its business is as important within the context of the statute as reaching the required capital ratio, especially when it is done in a way that does not significantly alter progress toward reaching the ratio. Considering that the 1990 statute initially gave FHA 10 years to grow its reserves to the 2 percent level, expecting FHA to return to that level far more rapidly after the worst economic downturn since the Great Depression is unrealistic and could put the taxpayer at increased, not decreased, risk.

Beyond the question of the premium reduction, it's important to understand exactly what the actuary is measuring and what the capital reserve ratio means. The actuary takes a very conservative approach, examining whether, if the agency were to stop insuring loans today, it has enough cash and reserves on hand to meet all of its existing insurance obligations. The 2 percent standard is unrelated to whether the agency has sufficient cash on hand to meet day-to-day obligations; the 46 billion it has is projected to be more than enough.[44] The 2 percent capital reserve ratio refers to a rainy-day fund, or a cushion, *over and above* the amount that the actuary currently believes is necessary to pay claims.

In the case of FHA, evaluating its financial position without accounting for its future business is especially conservative given that the agency's future business is likely to be far more profitable than in the past. The increased premiums FHA is collecting (even after the recently announced premium reduction), the policy and process improvements that are detailed in the previous section of this testimony, and the very high credit quality loans on its books are leading to record profits.[45] For example, the number of borrowers with credit scores below 620 has declined precipitously since 2008.[46] Loans insured from FY 2010 through 2014 are expected to contribute $45 billion to the fund over their lifetime (see Figure 4).

Figure 4:

Book Value by Cohort



SOURCE: FY 2014 Actuarial Review of the MMI Fund; analysis by U.S. Department of HUD/FHA.

Other indicators of high-quality business include the following:

- A 13 percent improvement in serious delinquency rates since last year.
- Loans insured in FY 2010 through 2013 are four times less likely to be seriously delinquent than loans insured from FY 2007 to 2009.
- Recovery rates—the amount of an insurance claim FHA can recover through actions such as home sales—have improved by 64 percent over the past two years.[47]
- Early payment delinquency rates—which is the rate at which borrowers miss three payments in the first six months after origination, and a good measure of whether the agency is insuring bad loans—have declined dramatically from about 2 percent in 2007 to only one-quarter of a percent in 2013.
- FHA's failure rate—the sum of to-date claims and loans in foreclosure—continues to improve for each subsequent book of business.[48]

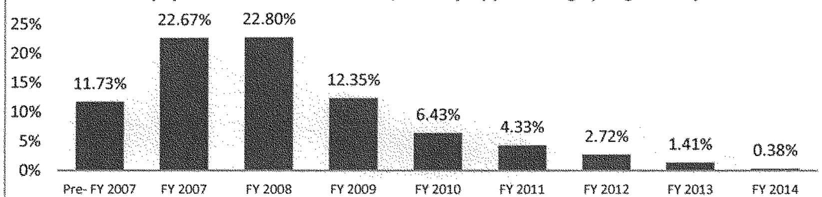
Note that the excellent performance of the loans described above is based on business that consists predominantly of low down payment loans made to households with credit scores typical of the American public. In FY 2014, 75 percent of borrowers had loan-to-value ratios above 95 percent, and the median borrower credit score was 680, which demonstrates the ongoing strength of the core FHA business model.

It is also likely that FHA's financial position will continue to improve because the strains of recent years were primarily due to projected and realized losses from FY 2007 through 2009 loans—loans strongly impacted by the recession and increases in unemployment, declining home price values, and low levels of premium revenue. (see Figure 5) During those years, FHA was ramping up its production 450 percent to compensate for the virtual collapse of private-label loans, realizing that investing in these loans would likely lead to losses, but those losses would pale in comparison to the losses suffered if the market were allowed to experience a devastating collapse.[49]

As noted previously, a significant portion of these losses stem directly from the seller-funded down payment assistance program, which is expected to lead to 25 percent of the losses in the 2007–2009 books and ultimately cost the agency $16 billion dollars in losses, according to the independent actuary.[50] If not for these loans, FHA would be significantly closer to meeting the 2 percent capital ratio, and it is unlikely it the agency would have required a draw from the Treasury.

Figure 5: **Crisis Era Loans Are Damaging FHA's Finances, Despite Strength of Recent Business**

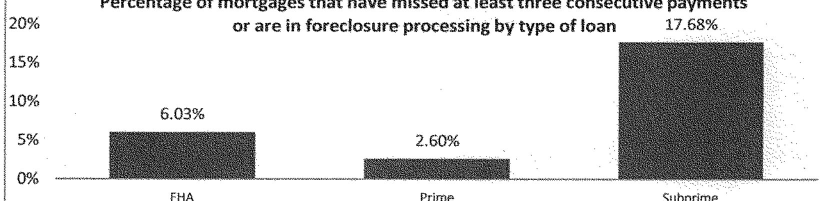
Percentage of FHA-backed mortgages that have missed at least three consecutive payments or are in foreclosure/bankruptcy processing by origination year



SOURCE: FHA Quarterly Report to Congress on FHA Single-Family Mutual Mortgage Insurance Fund Programs, Fourth Quarter of 2014

Overall, FHA-insured loans perform much better than subprime loans

Percentage of mortgages that have missed at least three consecutive payments or are in foreclosure processing by type of loan



SOURCE: Mortgage Bankers Association National Delinquency Survey, Fourth Quarter of 2014

Another significant contributor to FHA's financial weakness has been its reverse mortgage portfolio, which currently has an economic value of negative 1.17 billion. The new estimated value for reverse loans is a decline from the FY 2013 value, a decline primarily driven by expectations for higher interest rates in the long term. Due to the nature of reverse mortgages, most default risk lies far in the future, meaning that their value is extremely sensitive to small changes in interest rate expectations.[51]

Here too, FHA has made policy changes that will help its financial position, as noted previously. As a result of these changes, the independent actuary projects that the next five years of reverse mortgage originations will be profitable for FHA, which will reduce the shortfall FHA faces on this business line.[52]

III. Recommendations moving forward

While FHA has taken critical actions to protect taxpayers, strengthen their risk management, and ensure borrowers receive loans in which they can succeed, additional steps are still needed. We believe these steps will further reduce risk to the taxpayer while enhancing access to mortgage credit for qualified households and strengthening neighborhoods.

One very important way in which FHA lending could be made even safer is to encourage and fund broader availability of housing counseling. FHA had developed a pilot program to do so called the Homeowners Armed with Knowledge, or HAWK, program. HAWK would have connected new homebuyers with high-quality housing counseling in exchange for a reduction in mortgage insurance premiums. The program made good economic sense: Research suggests that pre-purchase housing counseling can play an important role in reducing loan delinquency rates, likely by ensuring that borrowers understand the risks and costs of homeownership and by encouraging borrowers to buy a home they can afford.[53] HAWK also included a yet-to-be-introduced component that would link troubled borrowers with housing counselors, which significantly improves a homeowner's chance of avoiding foreclosure.[54]

Unfortunately, Congress used the FY 2015 spending bill to prohibit HUD from implementing HAWK,[55] although due to the nature of the vote, there was no meaningful discussion or debate about the merits of the program. CAP strongly recommends that Congress reconsider this decision and discuss whether FHA could implement the program in a way that Congress would support.

Congress should also support FHA's ability to invest in its infrastructure and quality assurance processes. The administrative fee proposed in the administration's FY 2015 and 2016 budgets could serve as a starting point for discussions.[56] In the meantime, Congress can enable FHA to better manage its counterparties by giving the agency the authority it has requested to better monitor and enforce lender and servicer compliance, including enhanced indemnification authority, expanded authority to terminate lenders, and the authority to transfer servicing from underperforming servicers.

To encourage lenders to serve more borrowers, FHA should complete its work on its Quality Assurance Taxonomy and certification process, and it should also complete work on creating a supplemental performance metric as a companion to the Compare Ratio[57] that will take FHA's target mix of borrower characteristics into account when evaluating the performance of a lender's loans. By reducing lender uncertainty and combating misaligned incentives for lenders, each of these efforts will help expand access to credit for creditworthy borrowers who meet FHA's underwriting requirements. Congress can further support these efforts by giving FHA the authority it needs to modify the Compare Ratio.

While FHA has recently updated its loss mitigation requirements, including a revised set of alternatives to foreclosure that every servicer must consider before completing a foreclosure, many servicers do not appear to be complying with these rules. FHA should therefore require that a servicer provide clear proof that it complied with these new guidelines before it pays out an insurance claim. FHA also should require that its loan servicers give homeowners notice describing FHA's loss mitigation option and develop an effective mechanism through which homeowners can address a servicer's noncompliance with FHA's loss mitigation requirements. Additionally, as FHA continues developing its handbooks, it should continue to work with homeowner representatives to clarify important issues covered by the servicing handbook, such as treatment of successors-in-interest, the effect of bankruptcy, and relation of the handbook to existing regulations.

We also suggest the following improvements to the DASP note sales program.[58]

- FHA should require all buyers to work with existing homeowners to keep them in their homes if possible through a sustainable, permanent loan modification or to provide them with a foreclosure alternative such as a short sale or deed-in-lieu of foreclosure if a modification is not possible—perhaps using the Treasury Department's Making Home Affordable program.
- For properties where foreclosure cannot be avoided, FHA should require buyers to prioritize selling to owner-occupants, donating them to a nonprofit or local government or converting them into a well-maintained, affordable rental unit.[59]
- FHA should help nonprofits participate effectively in the bidding process because neighborhood-based nonprofits often produce the best outcomes for families and neighborhoods.
- Before placing loans in a sale pool, FHA should ensure that mortgage servicers have fully complied with the agency's requirements for attempting to assist borrowers and that the home is still occupied before placing a loan into distressed mortgage sale programs.
- FHA should collect and share more detailed performance data about the programs so the public can fully understand their effectiveness.

Another way that FHA can help hard-hit neighborhoods is to improve its mortgage product for homes that need rehabilitation, which is known as the 203(k) program. This program allows homebuyers to include renovation and repair costs in their mortgage. Beyond improving it for individual homeowners, FHA could provide expanded access to the program for nonprofit affordable-housing and community development groups.

To further improve reverse mortgages, HUD should provide meaningful protection for surviving spouses when they are not named on the loan to prevent them from losing their home at a very vulnerable time of life. Recently, HUD developed an option that would allow for the early assignment of the HECM mortgages at issue to the agency.[60] Unfortunately, most surviving spouses will not be able to use this option, both because many will not be able to come up with the funds necessary to qualify for the option and because a lender has discretion whether or not to permit this option.

In terms of involving private capital, if FHA considers pursuing single-family risk sharing as a means to more accurate pricing of FHA insurance and more protection of taxpayers, policymakers need to proceed cautiously and learn from the past. Previous programs of this nature have harmed FHA's bottom line due to improper alignment of incentives and considerations of the different objectives of counterparties.[61]

FHA has both a business and public policy function: it runs a large insurance company and should do so in a prudent and fiscally responsible manner. But its overarching mission is to serve borrowers and communities rather than to return a profit to shareholders. Private counterparties will focus only on the bottom line, which can be an effective force when properly harnessed but can sometimes conflict with FHA's policy goals. It is also important that private capital not cream profits in a way that would destabilize the insurance fund. Because of these different missions, it might make more sense to involve private capital and PMI companies in the national housing market through expanding the risk-sharing opportunities at Fannie Mae and Freddie Mac rather than through FHA.

However, if FHA moves in this direction, it should structure any efforts at risk sharing very deliberately to advance rather than compromise its mission. The agency will need to establish strong standards for counterparties, have the resources to adequately police these counterparties, and have the political independence necessary to enter into only those agreements that make sense and to terminate partnerships with bad partners as needed.

Finally, FHA should continue to explore how to improve risk estimates on FHA insurance. However, it would be a mistake to approach this problem by intentionally inflating the cost of that risk through so-called fair-value budget reporting. Instead of improving the accuracy of cost estimates for credit programs, it actually makes them less accurate by biasing apparent costs upward, and distorts the government's true fiscal position.[62] According to a recent analysis by Enterprise Community Partners, a shift to fair-value reporting would cost FHA $18 billion in resources, which could seriously limit FHA's availability to the market.[63] In other words, it could cause serious harm to programs such as FHA while doing nothing to actually reduce taxpayer exposure to loss.

Conclusion

FHA plays a key role in helping creditworthy homebuyers—especially those of modest means—obtain access to credit to purchase a home. Owning a home provides economic and social stability for middle-class families, builds wealth that can be leveraged and transferred across generations, and encourages residents to maintain their properties and invest in their communities.

In recent years, FHA has worked hard to balance its mission of supporting homeownership with its obligation to protect the insurance fund in a dynamic environment. Just as the significant increases in premiums over the past several years helped reverse the downward financial trajectory, the recent recalibration of the premium will help ensure that FHA continues to be available to the underserved borrowers that most need it.

Additionally, today's hearing highlights the importance of a continued conversation about the future of housing finance in America across all channels. Fannie and Freddie cannot remain in conservatorship indefinitely, and the market needs a steady supply of first-time homebuyers who can then become move-up homebuyers. Many of these buyers will be people of color or young people shouldering student debt, and they may not have the means to put 20 percent down. Important questions must be resolved about how to bring private capital back into the market, how to minimize government and taxpayer support while still providing long-term, sustainable lending, and how to serve the buyers of the future.

I welcome the opportunity to discuss these important matters with you in the coming months. Thank you again for inviting me today, and I look forward to your questions.

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Statement of Rohit Gupta

President & CEO of Genworth Mortgage Insurance &

Chairman of US Mortgage Insurers

Before

House Financial Services Subcommittee on Housing & Insurance

Thursday, February 26, 2015

Future of Housing In America: Oversight of FHA – Part II

Chairman Leutkemeyer and Ranking Member Cleaver, thank you for the invitation to testify before the House Financial Services Subcommittee on Housing & Insurance. My name is Rohit Gupta and I am the President and CEO of Genworth Mortgage Insurance. I also serve as Chairman of U.S. Mortgage Insurers ("USMI"), a trade association that began operations in 2014. USMI represents six of the industry's seven private mortgage insurers and is based here in Washington.

As private mortgage insurers, we play both a complementary and a competitive role with the Federal Housing Administration – the "FHA" -- by making it possible for home ready borrowers to purchase a home with less than a 20% down payment. We appreciate the opportunity to testify this morning on the important topic of the ongoing role of the FHA, and to answer the subcommittee's questions.

In my testimony this morning, I will cover the following topics:

- How private MI works, and how our industry differs from the FHA program –and why those differences matter.
- How private MI weathered the housing crisis, the lessons we learned and how we have used those lessons to strengthen our business model.
- How private MI is positioned to play an even more significant role to facilitate a stable and strong housing market going forward as work on housing reform continues.

<u>How Private MI Works – MI vs. FHA.</u>

The private mortgage insurance industry has been in existence for over 50 years. It is the primary form of private capital-backed credit enhancement for low down payment loans. We are regulated by state departments of insurance. States oversee our business conduct, review the rates we charge and establish capital requirements, generally at a risk to capital ratio of 25:1 (four percent of risk insured). In addition, Fannie Mae and Freddie Mac impose MI eligibility requirements that an MI must satisfy in order to be eligible to do business with the GSEs. Those standards, known as PMIERs, have been in place for decades and are in the process of being updated. The updates will include significantly higher capital requirements going forward.

Private MIs insure loans with down payments as low as three percent for borrowers with FICO scores down to 620. We underwrite loans based on a variety of factors. Our underwriting is grounded on the "3 Cs" of underwriting – credit (what is the borrower's history of managing his or her credit), capacity (does the borrower have the financial resources to meet his or her debt obligations) and collateral (is the down payment and home value sufficient to support the amount being borrowed). In the past year, MIs helped almost 600,000 borrowers purchase or refinance their homes. Almost half of the loans we insured went to first time homebuyers, and approximately 40% went to borrowers with incomes at or below $75,000.

FHA is a government guaranteed mortgage insurance program that was created in 1932. While the dimension of the program has changed over the years, its primary mission continues to be targeted at low and moderate income borrowers, members of underserved communities and first time homebuyers. The program insures loans with down payments as low as 3.5%, charging an upfront premium which typically is financed into the loan amount, and an annual premium that is added to the borrower's monthly mortgage payment. FHA insurance essentially covers 100% of losses in the event a borrower defaults, and the insurance coverage remains in place for the life of the loan.

The FHA's insurance fund is subject to a minimum statutory capital reserve requirement of two percent of the risk insured, although the FHA is permitted to continue insuring loans even if its capital falls below that statutory minimum. The FHA's capital ratio is currently 0.41% of risk insured, one-fifth of the required minimum.

The very business of the private MI industry is to put its own capital at risk in a first loss position on the loans we insure. This matters for several reasons, especially:

- Because we put our own capital are risk, we have a powerful incentive to verify that the loans we insure are prudently underwritten and sustainable. And, if a borrower experiences hardship, it makes good business sense for us to help that borrower stay in the home and avoid foreclosure. So our capital at risk aligns our interests with those of borrowers, mortgage lenders, investors and the overall housing market.

- Taxpayer risk is extremely remote on loans we insure. In the unfortunate event a loan defaults, borrower equity and our MI claim payment stand ahead of any GSE guarantee. In many cases, losses to the GSEs are far less on defaulted loans with MI than on bigger down payment loans that do not have MI coverage. See the Housing Finance Policy Center Brief entitled "Loss Severity on Residential Mortgages, Evidence from Freddie Mac's Newest Data" published by the Urban Institute in February 2015 for more on how MI mitigates losses to the GSEs.

- The MI business model builds capital during strong markets so that capital is available to pay claims during downturns. Mortgage insurance premium income, capital and reserve requirements combine to provide countercyclical protections against housing downturns. During times of market stress (for example, the "Oil Patch" in the mid-1980s), mortgage insurers experienced high levels of losses and our risk to capital levels rose accordingly. As markets stabilize, higher earned premiums and lower claims paid typically enable the industry to replenish our capital base. This countercyclical model was severely tested by the global financial crisis, and as expected, risk to capital ratios rose in the face of unprecedented losses. In recent years, housing markets have recovered, loan performance has improved, MIs adjusted our guidelines and pricing, and our industry has attracted significant amounts of new capital. These factors have combined to result in materially improved risk to capital ratios. Today, our industry is well positioned to pay claims and write new business.

How MI Weathered the Crisis/Lessons Learned.

Like all of the housing finance market, our industry faced unprecedented challenges as a result of the global financial crisis. But USMI member companies never stopped paying claims, and we never received any bailout money from the federal government. Since the onset of the housing crisis, our industry has covered over $44 billion in claims to the GSEs, claims that otherwise would have been on the shoulders of taxpayers. And we have attracted approximately $10 billion in new capital during this time. Three MI companies did exit the business, but they all continue paying claims. In addition, three new companies have entered the business since 2008: a significant vote of confidence in the private MI business model [See Appendix A for a snapshot of the state of the MI industry].

Coming through the housing cycle, we heard concerns from investors and counterparties regarding our willingness to pay claims, our ability to pay claims and lack of transparency into our claims paying practices. And we addressed each of those concerns, working closely with state regulators, FHFA and the GSEs. We have significantly shored up our capital with all companies operating at capital ratios of 18:1 or better. This is equivalent to capital of at least five percent of risk insured for all MIs. In October 2014, each MI put into effect new master policies that provide contractual certainty regarding how and when we pay claims. Later this year, the GSEs and FHFA will finalize revised PMIERs that will require our industry to operate under new risk-based capital requirements significantly higher than our current requirements. The revised PMIERs will represent a reliable, transparent and comprehensive counterparty framework that sets standards for both capital and operational capacity for our industry.

The Role of MI Going Forward.

The Committee asked us to comment on FHA's role as it relates to the re-entry of private capital. Our industry differs from the FHA in some fundamental ways, and those differences enable private MIs to play an important role in a sound and stable housing finance market. FHA and private MIs can and should serve as complementary forces that enable the FHA to remain focused on its fundamental mission of serving underserved markets that the private sector may not be best suited to reach. But for this model to work properly, it is critically important that the FHA not stray too far afield from that mission [See Appendix B for a high level comparison of Private MI and FHA].

The recent decision to lower annual mortgage insurance premiums at FHA, for example, has two immediate consequences: (1) it slows the trajectory of FHA attaining the 2% minimum capital requirement; and, (2) it limits the ability of private MI companies to serve their traditional role in higher LTV markets [See Appendix C for charts detailing the impact of the FHA price decrease]. These consequences matter for a housing finance system that is still rebounding from the 2007-2008 cycle and for a system – by most every account – preferring the return of private capital to support U.S. housing finance.

To summarize, the private MI industry is not merely "an alternative to FHA," we are a highly capitalized, strongly regulated, proven countercyclical credit enhancement that reduces taxpayer exposure. We are among the best positioned to continue to serve the housing market as it exists today and as you consider housing finance reform going forward. The current application of Standard Cover private mortgage insurance is a very good place to start – as recognized in most of the GSE reform efforts included in the 113th Congress [See Appendix D for a description of Standard Coverage]. But more can be done to make the risk to the federal government even more remote:

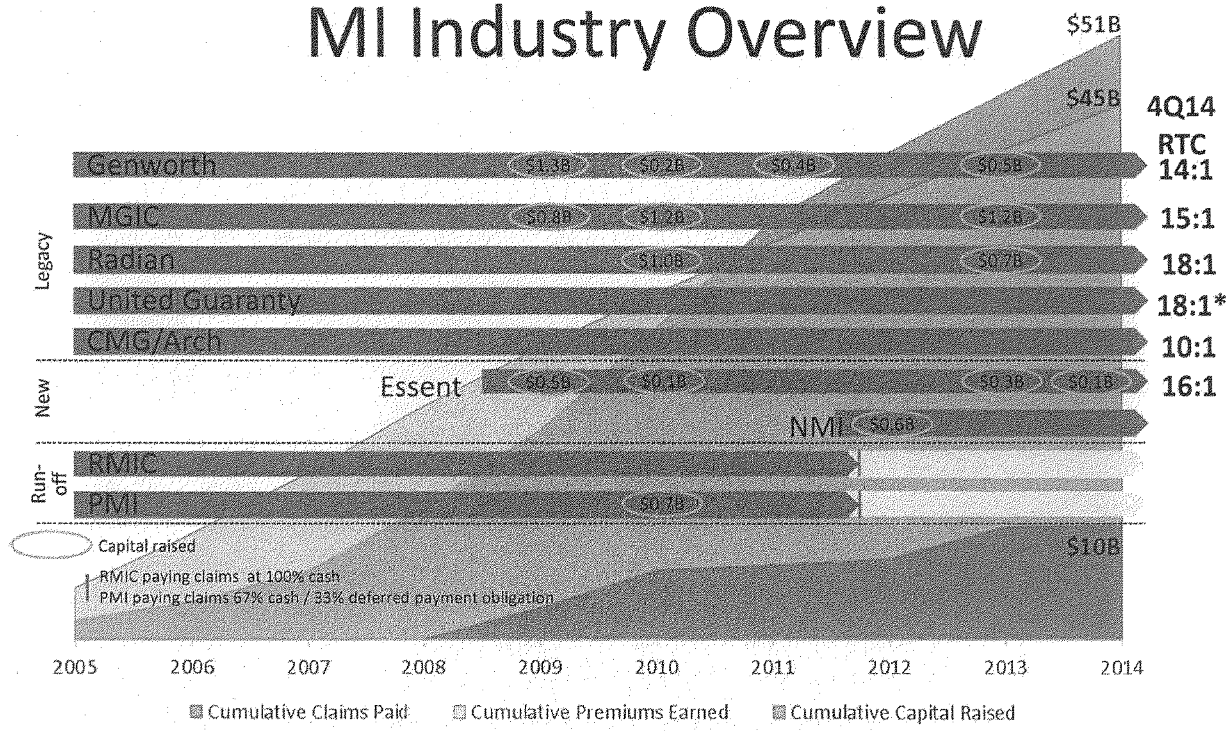
- Beyond or in addition to Standard Cover, encourage supplemental or deeper private credit enhancements to further distance the government exposure; and,
- Encourage the use of additional risk sharing to transfer real risk from the government balance sheet – both the GSEs and with FHA – over to private MIs.

As Congress continues the important work on comprehensive housing finance reform, we strongly believe that reform should include a single industry wide standard on QM (Qualified Mortgages); there should be a single industry standard for permissible seller concessions (three percent permitted in the conventional market); and there should be a common sense approach to FHA loan limits tied to current home prices in each geographic region.

We appreciate the opportunity to testify before this subcommittee and look forward to responding to any questions you may have.

Appendix A

MI Industry Overview



Note: Excludes any capital benefit from reinsurance agreements entered into in 2008. Claim and Premium data through 3Q14.
Sources: SEC/GAAP for GNW, MGIC, Radian, UG. Combined Yellow Book Data Pre-2013 for GNW, MGIC, Radian, UG, PMI CMG, Essent, RMIC. RTC ratios disclosed by each MI.
* United Guaranty discloses Risk To Capital ratio on a lag. 3Q14 shown here.

Appendix B

USMI
U.S. Mortgage Insurers

When It Comes To Protecting Taxpayers, There's No Comparison
Private Mortgage Insurance (MI) vs. FHA

Issue	Private MI	FHA
Who Bears the Risk In a Default	Private capital assumes the credit risk in a first loss position.	The FHA assumes 100 percent of the risk so given the under capitalization of the MMI fund, taxpayers are at risk if there are not sufficient funds available for FHA to pay its claims.
Taxpayer Impact	Covered approximately $44 billion in losses on loans sold to the GSE's since they entered conservatorship, losses that otherwise would have been shouldered by taxpayers.	The FHA insurance fund required $1.7 billion from U.S. taxpayers due to a capital shortfall. Even after this bailout, and with additional funds from one-time litigation settlements and enforcement actions, the fund is *still* undercapitalized.
How Price is Determined	More granular, risk based rates based on robust actuarial analysis and a real cost of capital, requiring state level filings.	Flat pricing structure based on limited actuarial modelling with little approval oversight.
Underwriting Incentives	Covers first losses down to a stated coverage percentage. The potential for some lender/investor loss in severe cases creates strong incentive for prudent underwriting and strong servicing.	Covers 100 percent of losses if a loan defaults, which may provide less incentive to ensure that loans are underwritten and serviced in prudent and sustainable manner.
Capital, Leverage, and Oversight Requirements	Required to be at a minimum capital ratio of 4 percent. All MIs are reporting risk to capital ratios less than 18:1. Even higher capital standards will be required under final GSEs Private Mortgage Insurer Eligibility Requirements (PMIERs).	Required to be at a minimum capital ratio of 2 percent. FHA insurance fund is at a 0.41 percent capital ratio, well below the two percent statutory minimum. FHA insurance fund has been below 2 percent since 2009, is not expected to reach 2 percent until 2017 at earliest, and will not reach more prudent 4.5 percent level suggested by analysts until the mid-2020s.
Coverage	For most premium plans, by federal law, coverage (and premiums) cancels when the loan LTV reaches approximately 78 percent.	Stays in place for the life of a loan. Therefore, it is essential that FHA charge borrowers premiums throughout the life of each loan. FHA loans are also assumable (meaning a new borrower can assume the mortgage loan and the FHA insurance stays in place), which makes life of loan coverage necessary.

Appendix C

FHA Premium Reduction Will Impact FHA and Private MI Market Share

Impact of FHA Price Decrease With Typical Ginnie Mae/GSE Bond Spreads:

		FHA	Conventional (by FICO)									
			620 - 639	640 - 659	660 - 679	680 - 699	700 - 719	720 - 739	740 - 759	760 - 779	780 - 799	800+
BEFORE	85% LTV	$1,262	$1,219	$1,219	$1,206	$1,163	$1,150	$1,127	$1,121	$1,114	$1,114	$1,114
	90% LTV	$1,337	$1,351	$1,337	$1,323	$1,270	$1,263	$1,225	$1,219	$1,209	$1,209	$1,209
	95% LTV	$1,411	$1,513	$1,498	$1,484	$1,404	$1,397	$1,329	$1,322	$1,306	$1,306	$1,306
	97% LTV	$1,443	$1,619	$1,596	$1,582	$1,525	$1,525	$1,468	$1,461	$1,451	$1,451	$1,451
AFTER	85% LTV	$1,174	$1,219	$1,219	$1,206	$1,163	$1,150	$1,127	$1,121	$1,114	$1,114	$1,114
	90% LTV	$1,243	$1,351	$1,337	$1,323	$1,270	$1,263	$1,225	$1,219	$1,209	$1,209	$1,209
	95% LTV	$1,312	$1,513	$1,498	$1,484	$1,404	$1,397	$1,329	$1,322	$1,306	$1,306	$1,306
	97% LTV	$1,343	$1,619	$1,596	$1,582	$1,525	$1,525	$1,468	$1,461	$1,451	$1,451	$1,451

Assumes $250,000 home price, 4% FHA rate & 4.5 - 5% Conventional mortgage rate

The Impact of FHA Price Decrease Is Material Even With Unusually Tight Bond Spreads*:

		FHA	Conventional (by FICO)									
			620 - 639	640 - 659	660 - 679	680 - 699	700 - 719	720 - 739	740 - 759	760 - 779	780 - 799	800+
BEFORE	85% LTV	$1,262	$1,199	$1,199	$1,187	$1,144	$1,131	$1,108	$1,102	$1,095	$1,095	$1,095
	90% LTV	$1,337	$1,330	$1,316	$1,303	$1,250	$1,243	$1,205	$1,199	$1,189	$1,189	$1,189
	95% LTV	$1,411	$1,491	$1,477	$1,462	$1,382	$1,375	$1,308	$1,301	$1,285	$1,285	$1,285
	97% LTV	$1,443	$1,596	$1,574	$1,560	$1,504	$1,504	$1,447	$1,440	$1,429	$1,429	$1,429
AFTER	85% LTV	$1,174	$1,199	$1,199	$1,187	$1,144	$1,131	$1,108	$1,102	$1,095	$1,095	$1,095
	90% LTV	$1,243	$1,330	$1,316	$1,303	$1,250	$1,243	$1,205	$1,199	$1,189	$1,189	$1,189
	95% LTV	$1,312	$1,491	$1,477	$1,462	$1,382	$1,375	$1,308	$1,301	$1,285	$1,285	$1,285
	97% LTV	$1,343	$1,596	$1,574	$1,560	$1,504	$1,504	$1,447	$1,440	$1,429	$1,429	$1,429

Assumes $250,000 home price, 4% FHA rate & 4.5 - 5% Conventional mortgage rate

*Immediately following announcement of the FHA price decrease, the bond spread fell as low as 25bps due to the sharp increase in FHA refinances. Spreads have since widened and are expected to return to a more traditional ~100bps as the pace of FHA refinances slows.

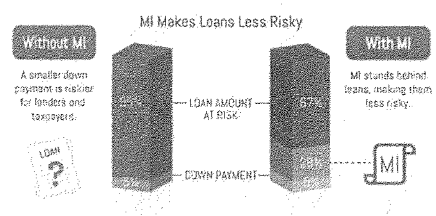
Appendix D

USMI
U.S. Mortgage Insurers

Private Mortgage Insurance (MI) plays a significant role in making taxpayer risk more remote on low down payment GSE loans. The GSE charters set minimum requirements for MI coverage, known as "Charter Coverage" because it satisfies the legal charter requirement. However, while charter coverage is legally sufficient, it does not afford any additional economic protection against loss from default, and is not commonly used in the market today. Instead, FHFA and the GSEs either require deeper coverage ("Standard Coverage") or charge significant loan level fees to self-insure against the additional risk associated with shallow charter coverage. Standard coverage brings loan exposure down to less than 75% of property value so that, except in the case of extremely severe declines in a home's value, the GSEs incur no losses.

For nearly 20 years the market practice for GSE loans has been to use standard coverage, which has served the housing finance system well and represents a vital source of private capital on GSE loans, providing substantial taxpayer protection at an affordable cost to borrowers.

Standard coverage was appropriately made part of most housing reform proposals. The benefits of standard MI coverage should be preserved when considering policy alternatives to ensure that taxpayers are at a more remote risk of loss in any reformed system. Indeed, deeper and broader use of MI could readily limit taxpayer exposure further. Importantly, the expanded use of MI is fully compatible with the functioning of the GSE (TBA) securitization market, which is vital to providing borrowers access to affordable 30-year fixed rate mortgages. MI provides policy makers a tool already used by lenders of all sizes with which to build a new housing finance system where private capital stands in front of taxpayer risk.



ABOUT USMI

U.S. Mortgage Insurers (USMI) is dedicated to a housing finance system backed by private capital that enables access to housing finance for borrowers while protecting taxpayers. Mortgage insurance (MI) offers an effective way to make mortgage credit available to more people. USMI is ready to help build the future of homeownership. For more information, visit www.usmi.org

The Future of Housing in America: Oversight of the Federal Housing Administration, Part II

United States House of Representatives
Committee on Financial Services
Subcommittee on Housing and Insurance

Douglas Holtz-Eakin, President*
American Action Forum

February 26, 2015

*I thank Marisol Garibay, Sarah Hale, and Andy Winkler for their assistance. The views expressed here are my own and not those of the American Action Forum.

Chairman Luetkemeyer, Ranking Member Cleaver, and members of the committee, thank you for the opportunity to appear today and share my views on the financial status of the Federal Housing Administration (FHA). It is vitally important to reassess the health of FHA's Mutual Mortgage Insurance Fund (MMIF) in light of recent reductions in premiums. In this testimony, I wish make three basic points:

- FHA's annual mortgage insurance premium reduction stands to seriously affect the trajectory of the MMIF and ongoing efforts to limit the government's footprint in housing finance. I applaud the committee for taking a critical look at the implications of this decision,

- HUD and FHA officials have prioritized borrower savings over statutory requirements and the MMIF's financial integrity. Their actions ignore recent history and jeopardize FHA's ability to fulfill its mission going forward,

- Finally, the decision to prematurely reduce premiums only underscores the long overdue need to simultaneously reform FHA and address damaging weaknesses in the U.S. housing finance system.

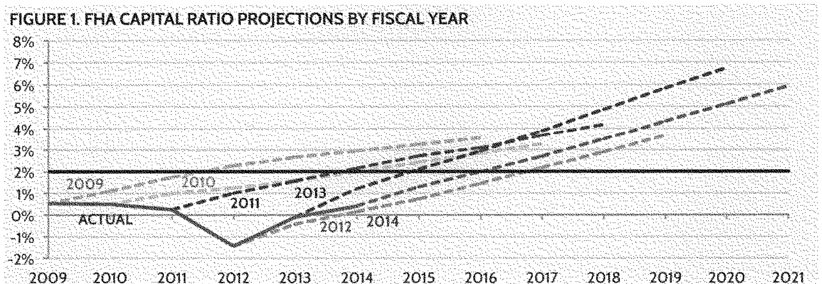
Let me provide additional detail on each in turn.

FHA's Fiscal Outlook

Background

After the housing bubble burst, FHA expanded the scope of its mortgage insurance program in response to the massive loss of private liquidity. In this effort, FHA depleted its capital reserves and required $1.7 billion from the Treasury Department in 2013 to bolster its finances.

FIGURE 1. FHA CAPITAL RATIO PROJECTIONS BY FISCAL YEAR



SOURCE: FHA ACTUARIAL REPORTS FY 2009 - 2014

The capital ratio represents the economic value of the MMIF (essentially assets less liabilities plus the projected cash flow of current books) as a percentage of FHA's total insurance-in-force. FHA reported its capital ratio in FY 2014 to be 0.41 percent, lower than the 1.22 percent that was previously estimated.[1] The projected return to FHA's congressionally mandated minimum has therefore been pushed back another year to 2016 as shown in Figure 1.

Effects of Premium Reduction

Announced in advance of President Obama's state of the union address and effective January 26, 2015, FHA lowered annual mortgage insurance premiums by 50 basis points (bp) or 0.50 percent, the latest in a concerted effort to expand credit availability.[2] This decision directly affects FHA's fiscal outlook in these ways:

- ***Lower prices mean less revenue.*** Cutting annual premiums by nearly 40 percent will expectedly reduce incoming cash flow. It would be difficult for FHA to pull in enough new volume above prior projections to make up that loss in revenues. Furthermore, those new volumes would have to come from borrowers previously priced out or borrowers that would have chosen private mortgage insurance. And both options come with caveats. Buyers who found FHA cost-prohibitive previously and were therefore unable to purchase a home are likely to have high loan-to-value ratios (LTVs) and/or low FICO scores that private mortgage insurers would not serve without higher pricing to compensate for the risks. These borrowers are more likely to become delinquent and therefore result in losses for FHA, which could easily turn to taxpayer losses without a restored capital buffer. The second option, pulling borrowers away from private companies, runs firmly against the bipartisan policy objective of limiting the government's involvement in mortgage markets following years of unprecedented and risky government support.

- ***Delay reaching congressional mandate.*** In its last actuarial report, FHA's capital ratio was projected to reach exactly 2.0 percent in 2016. Even a small reduction in incoming cash flow will easily push FHA short of reaching that projected capital ratio, all else staying equal. Regardless of the premium reduction impact, the MMIF's economic value has come in consistently lower than estimated for the past 12 fiscal years. In FY 2012 alone, actual economic value was $22.8 billion less than projected.

- ***More refinancing.*** When coupled with interest rates near their lowest level since mid-2013, the reduction in premiums may also encourage a number of FHA borrowers to refinance into lower payments. The Urban Institute estimated that 2.4 million current borrowers could stand to benefit from refinancing.[3] Satish Manusukhani of BofA Merrill Lynch similarly estimated three million borrowers could save money by refinancing, though many would not.[4] Increased refinancing could further reduce expected revenue by encouraging prepayment.

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[1] The capital ratio can be calculated by combining the economic values of MMIF and HECM Fund divided by the total amortized insurance-in-force found here: http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/actr/actrmenu

[2] HUD Press Release, *FHA to Reduce Annual Insurance Premiums*, (January 8, 2015); http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2015/HUDNo_15-001

[3] Karen Kaul, Laurie Goodman, & Jun Zhu, Urban Institute, *More than one in three FHA borrowers could save money by refinancing today*, (February 16, 2015); http://blog.metrotrends.org/2015/02/fha-borrowers-save-money-refinancing-today/

[4] Joe Light, WSJ, *Fee Cut, Lower Rates Could Boost Mortgage Refinancings*, (January 12, 2015); http://www.wsj.com/articles/fee-cut-lower-rates-could-boost-mortgage-refinancings-1421105102

- ***Added risk.*** As mentioned previously, in lowering premiums FHA is attracting two kinds of borrowers—those that would have otherwise chosen private mortgage insurance or borrowers with high LTVs and/or low FICO scores that had been priced out of the market. The 50-bp reduction in premiums allows FHA to undercut conventional pricing for many mortgages with very low down payments and those for borrowers with low FICO scores, loan characteristics generally acknowledged to have greater inherent risk.[5]

- ***Pushes out private capital.*** Discussed in further detail below, FHA stands to undercut private mortgage insurers by reducing prices, which may increase FHA's market share at a time when the government should be reducing its footprint in housing finance.

Documented History of Missed Projections

Adding to concern surrounding premium reductions, FHA's recent history has been plagued by missed projections. These missed projections enhance the perception that FHA downplays risks borne by taxpayers and cast doubt on the assumption that FHA will continually improve as projected despite cutting annual premiums. Since FY 2009, FHA's capital ratio has been below the 2 percent minimum mandated by Congress. FHA has repeatedly projected marked improvement only to miss its targets (see Figure 1).

In every actuarial review since 2003, the economic value of FHA's MMIF has come in lower than what was projected the previous year (see Table 1). While FHA has in the past pointed to programs like home equity conversion mortgages (HECM) or the prevalence of seller-funded down payment assistance for losses greater than anticipated, erroneous economic assumptions and volume forecasts are more frequently to blame.

TABLE 1. MMIF ECONOMIC VALUE ($ BILLIONS)

	PROJECTION	ACTUAL	DIFFERENCE
2000	$16.64	$16.96	$0.32
2001	$20.23	$18.51	-$1.72
2002	$22.54	$22.64	$0.10
2003	$27.27	$22.74	-$4.53
2004	$27.70	$21.98	-$5.72
2005	$24.43	$21.62	-$2.81
2006	$22.70	$22.02	-$0.68
2007	$23.13	$21.28	-$1.85
2008	$22.75	$12.91	-$9.84
2009	$15.82	$2.73	-$13.09
2010	$7.88	$5.16	-$2.72
2011	$10.97	$1.19	-$9.78
2012	$9.35	-$13.48	-$22.83
2013	-$2.59	-$7.87	-$5.29
2014	$7.84	$5.93	-$1.91

SOURCE: FHA ACTUARIAL REPORTS, FY 2000 – FY 2014

[5] See Ken Lam, Robert M. Dunsky & Austin Kelly, FHFA, *Impacts of Down Payment Underwriting Standards on Loan Performance – Evidence from the GSEs and FHA Portfolios*, (December 2013); http://www.fhfa.gov/policyprogramsresearch/research/paperdocuments/2013-12_workingpaper_13-3-508.pdf

Following the dramatic fall in FHA's economic value shown in Table 1, legislative attempts to reform FHA in the last Congress would have raised its mandated capital ratio even higher. Reform proposals have included a new capital ratio of either 3 percent or 4 percent, levels FHA's MMIF is not expected to reach until 2018 and 2019 respectively before factoring in the effects of premium reductions.[6] FHA's capital buffer is meant to protect taxpayers in an economic downturn while preserving FHA's ability to fulfill its mission; its restoration is critical. Furthermore, many rightly worry that FHA's current economic value is overstated due to the influx of money from major mortgage-related legal settlements and the one-time appropriation of $1.7 billion from the Treasury Department (see Table 2).

TABLE 2. MAJOR SETTLEMENTS

	SETTLEMENT PAYMENT TO FHA	AUDIT REPORT	DATE
BANK OF AMERICA/COUNTRYWIDE	$471,000,000	2012-CF-1809	JUNE 2012
DEUTSCHE BANK/MORTGAGEIT	$196,000,000	2012-CF-1811	JULY 2012
CITI	$122,800,000	2012-CF-1814	SEPTEMBER 2012
ALLY FINANCIAL, BANK OF AMERICA, CITI, JPMORGAN CHASE, & WELLS FARGO	$315,200,000	2012-CH-1803	SEPTEMBER 2012
JP MORGAN CHASE	$336,000,000	2014-CF-1807	SEPTEMBER 2014
REUNION	$1,040,000	2014-CF-1810	SEPTEMBER 2014
BANK OF AMERICA	$437,600,000	2014-FW-1808	SEPTEMBER 2014
US BANK	$144,199,970	2014-CH-1801	SEPTEMBER 2014
SUNTRUST	$300,000,000	2015-PH-1802	DECEMBER 2014
TOTAL	$2,323,839,970		

SOURCE: HUD OFFICE OF INSPECTOR GENERAL (HUDOIG) AUDIT REPORTS

Since 2012, the MMIF has been bolstered by at least $4 billion in funds from legal settlement money and the one-time Treasury infusion. Despite that, the MMIF's capital ratio is still below its mandate.

Market-Shifting Implications

TABLE 3. FHA VS. CONVENTIONAL MORTGAGE MONTHLY PAYMENTS BY LTV

		FHA	CONVENTIONAL (BY FICO) 620-639	640-659	660-679	680-699	700-719	720-739	740-759	760-779	780-799	800+
BEFORE	85 LTV	$1,262	$1,219	$1,219	$1,206	$1,163	$1,150	$1,127	$1,121	$1,114	$1,114	$1,114
	90 LTV	$1,337	$1,351	$1,337	$1,323	$1,270	$1,263	$1,225	$1,219	$1,209	$1,209	$1,209
	95 LTV	$1,411	$1,513	$1,498	$1,484	$1,404	$1,397	$1,329	$1,322	$1,306	$1,306	$1,306
	97 LTV	$1,443	$1,619	$1,596	$1,582	$1,525	$1,525	$1,468	$1,461	$1,451	$1,451	$1,451
AFTER	85 LTV	$1,174	$1,219	$1,219	$1,206	$1,163	$1,150	$1,127	$1,121	$1,114	$1,114	$1,114
	90 LTV	$1,243	$1,351	$1,337	$1,323	$1,270	$1,263	$1,225	$1,219	$1,209	$1,209	$1,209
	95 LTV	$1,312	$1,513	$1,498	$1,484	$1,404	$1,397	$1,329	$1,322	$1,306	$1,306	$1,306
	97 LTV	$1,343	$1,619	$1,596	$1,582	$1,525	$1,525	$1,468	$1,461	$1,451	$1,451	$1,451

NOTE: ASSUMES $250,000 HOME PRICE, 4% FHA & 4.5-5% CONVENTIONAL MORTGAGE RATE
SOURCE: DATA FROM GENWORTH & AUTHOR'S CALCULATIONS

[6] See S.1376, §9 - FHA Solvency Act of 2013; https://www.congress.gov/bill/113th-congress/senate-bill/1376 and H.R. 2767, §256(b) - the Protecting American Taxpayers and Homeowners Act of 2013; http://thomas.loc.gov/cgi-bin/bdquery/z?d113:h.r.02767:

The outsized role the government plays in housing continues to be a primary bipartisan concern, yet lowering FHA premiums will exacerbate that problem. The effort will likely preserve or even expand FHA's market share by making its mortgage insurance cheaper for prospective borrowers than what is offered by private companies. In Table 3, boxes are shaded red if FHA-insured mortgages elicit cheaper monthly payments than conventional mortgages (private mortgage insurance with a GSE guarantee). Conversely, they are shaded green if conventional mortgages would have lower monthly payments than FHA.

With the reduction, FHA is more competitive amongst FICOs below 680 and narrows the gap for FICOs between 680 and 720, regardless of LTV. Though other factors play into choosing whether to opt for private mortgage insurance or FHA, pricing premiums lower across the board makes FHA a cost effective choice for many more borrowers.

Adding to the likelihood that FHA captures business that might otherwise go to private mortgage insurers, the implementation window for the premium reduction was made curiously short when compared to prior premium changes, giving companies little time to adjust. Shown in Table 4, the announced 50 bp decrease in annual premiums became effective January 26, only nine business days after FHA released a mortgagee letter instructing lenders on the change. Earlier premium changes gave mortgage market participants anywhere from 22 to 82 business days between announcement and effective dates.

TABLE 4. FHA PREMIUM CHANGES SINCE 2010

	MORTGAGEE LETTER	ANNOUNCEMENT DATE	EFFECTIVE DATE	DAYS TO IMPLEMENT*
50 BP UFMIP INCREASE	2010-02	JANUARY 21, 2010	APRIL 5, 2010	50
125 BP UPMIP DECREASE & 35 BP ANNUAL MIP INCREASE	2010-28	SEPTEMBER 1, 2010	OCTOBER 4, 2010	22
25 BP ANNUAL MIP INCREASE	2011-10	FEBRUARY 14, 2011	APRIL 18, 2011	43
10 BP ANNUAL MIP INCREASE & 75 BP UFMIP INCREASE	2012-04	MARCH 6, 2012	APRIL 9, 2012	23
25 BP ANNUAL MIP INCREASE**	2012-04	MARCH 6, 2012	JUNE 11, 2012	67
10 BP ANNUAL MIP INCREASE	2013-04	JANUARY 31, 2013	APRIL 1, 2013	40
45 BP ANNUAL MIP INCREASE***	2013-04	JANUARY 31, 2013	JUNE 3, 2013	82
50 BP ANNUAL MIP DECREASE	2015-01	JANUARY 9, 2015	JANUARY 26, 2015	9

* BUSINESS DAYS ONLY—EXCLUDES WEEKENDS AND FEDERAL HOLIDAYS

**FOR LOANS EXCEEDING $625,500

*** FOR LOANS WITH LTV < 78 PERCENT

NOTE: FHA CHARGES TWO FEES – AN UPFRONT MORTGAGE INSURANCE PREMIUM (UFMIP) AND ANNUAL MORTGAGE INSURANCE PREMIUM (ANNUAL MIP). THE RECENT PREMIUM ANNOUNCEMENT IS A 50 BP REDUCTION IN THE ANNUAL MIP, WHICH IS PAID OVER THE LIFE OF THE LOAN WHEREAS THE UPFMIP IS DUE WHEN THE LOAN IS INITIALLY MADE.

Need for Reform

FHA gained significant market share at a time when lending seized up and home prices were still falling. For the past several years, the critical question has become how to rebuild FHA's solvency, return it to its original mission, and return private capital to the market. Normally self-funded through premiums, the FHA required $1.7 billion from the Treasury Department to bolster its finances to cover losses, largely from books of business after the housing bust and the FHA's reverse mortgage program. Most legislative proposals to overhaul the FHA have failed to pass both houses despite consistent bipartisan support for reform. There are three critical goals to FHA reform:

- Limit mortgage insurance to a defined and qualified target group,
- Return the FHA to its mandated capital requirement and limit future taxpayer losses, and
- Coordinate reform of the larger housing finance system and the return of private capital with changes to the FHA.

With the passage of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) and the accompanying Federal Credit Reform Act of 1990 (FCRA), Congress required FHA to operate on an actuarially sound basis, with a capital ratio of 2 percent of insurance-in-force and an annual actuarial review conducted by an independent contractor. Yet these safeguards have been insufficient as there are few to no consequences for FHA when its capital ratio falls below the mandated level.

The PATH Act passed by the House Financial Services Committee last Congress would have made significant changes to both the structure and operations of the FHA. When evaluated on the basis of the three goals of FHA reform, the bill would have clearly limited mortgage insurance to a defined group, first-time homebuyers and low- and moderate-income homebuyers, increased FHA's capital buffer and enhanced the role of the private market. Notably, by addressing FHA in conjunction with a wind down of the GSEs, the bill was also cognizant of how misaligned pricing limits and standards can shift market share between government-backed entities instead of drawing in private capital. With FHA lowering premiums and recent actions at FHFA to encourage high LTV lending, now is the time for both houses of Congress to revisit efforts to reform both FHA and the GSEs.

Testimony of

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Before the Subcommittee on Housing and Insurance

Of the Committee on Financial Services

United States House of Representatives

"The Future of Housing in America: Oversight of the Federal Housing Administration - Part II"

February 26, 2015

Introduction

Chairman Luetkemeyer, Ranking Member Cleaver, and Members of the Committee, thank you for the opportunity to testify on the financial condition of the Federal Housing Administration's (FHA) Mutual Mortgage Insurance Fund (MMIF, or the Fund) and the role of FHA in the marketplace. I am currently a professor-of-the-practice and executive-in-residence at the Robert H. Smith School of Business at the University of Maryland, as well as chief economist for Radian Group, Inc. Prior to my roles at the University of Maryland and Radian, I spent more than 20 years managing or leading risk management functions at major commercial financial institutions, Fannie Mae and Freddie Mac, a bank regulatory agency and the U.S. Department of the Treasury.

My testimony today focuses on three areas: (1) the problems associated with assessing the financial condition of the MMIF, (2) the effect of the FHA's recent decision to lower annual mortgage insurance premiums (MIPs), and (3) areas for reforming FHA. I also offer several recommendations that would secure the financial viability of FHA while also clarifying and sustaining its role in the housing finance system. These include:

- Application of area median income targets to better define FHA's mission;
- Development of risk-sharing arrangements;
- Harmonizing the conflicting definitions of a "Qualified Mortgage";
- Tethering FHA's risk model assumptions to line up to the GSEs in order to have consistent comparisons.

Unquestionably, FHA has served a critical role in our nation's housing market by providing affordable credit to over 40 million first-time homebuyers and other borrowers with limited resources who otherwise would have difficulty obtaining access to credit through more traditional private-sector sources. At the same time, FHA, in its capacity as public steward of the $1 trillion-plus MMIF, has responsibility for maintaining the financial integrity of that fund which, according to recent actuarial analyses, has lately experienced considerable stress. Also, FHA should not take actions to displace the private mortgage insurance industry, which is serving the housing market well, and is willing and able to do even more.

The Problems with Assessing the Financial Condition of the MMIF: Actuarial Model Flaws.

According to the latest actuarial analysis, the MMIF (including Home Equity Conversion Mortgages) remains in an extremely weak position. By statute, the FHA is required to maintain a ratio of capital to amortized insurance-in-force of at least two percent.[1] Each year, an actuarial analysis is performed to determine the economic value of the MMIF in relation to amortized insurance-in-force. Since 2009, the MMIF has not met this required ratio. In 2013, the MMIF required a mandatory appropriation from the U.S. Treasury of approximately $1.7 billion, after the determination that the Fund did not have sufficient reserves to pay all expected losses.[2]

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[1] Cranston-Gonzalez National Affordable Housing Act of 1990.

[2] Written Testimony of Carol Galante, Assistant Secretary for Housing/FHA Commissioner, U.S. Department of Housing and Urban Development (HUD), Hearing before the House of Representatives Committee on Financial Services, October 29, 2013, p.2.

Today that capital ratio is at only .41 percent.[3] To put that deficiency in perspective, if the MMIF were a commercial banking enterprise, under Prompt Corrective Action (PCA) requirements, it would be taken into receivership by the FDIC.[4]

The 2014 MMIF actuarial report estimates that the Fund will reach the two percent capital reserve ratio threshold by 2016. To get there, economic value is projected to increase from $4.8 billion in 2014 to $23.4 billion in 2016, a nearly 400 percent increase in two years.[5] However, that projection assumes that the data, forecasts, assumptions and models supporting the actuarial analysis are empirically supportable. One of the most pernicious risks financial institutions face is **model risk**. During the years leading up to the financial crisis, many Wall Street firms and banks fell under the spell of highly complex models for risk and valuation analysis. These models, in many instances, broke down and materially underestimated credit risk as key assumptions and relationships between default and risk factors were, ultimately, flawed. The FHA's actuarial model is no less susceptible to these issues and it is worth describing how a number of features of the actuarial model throw the estimates of economic value and insurance-in-force into significant doubt.

I am particularly concerned about the accuracy of the FHA's models when viewed in light of the fact that they are at least partially relied upon for providing the FHA with confidence in its current pricing policy decisions.

The actuarial model used to value the MMIF is acceptable in theory, but it is extraordinarily complex. Importantly, its underlying assumptions are cause for concern and further discussion. The model incorporates numerous statistical models describing how FHA loans transition from one performance state, such as current, to another state, such as delinquent or prepayment over the life of a mortgage. In addition, models are developed to predict the severity of loss once a loan defaults. Other models are developed to forecast FHA mortgage volume and include projections of future FHA loans' credit-risk profile. These models are developed using loan-level FHA data that feature a variety of borrower, loan, property, and macroeconomic factors, among others. Important macroeconomic factors that explain a default event include changes in home price and unemployment rates. Interest rates are a key driver in the model for predicting prepayments. A number of these models are interdependent, thus adding to their complexity, and are subject to considerable volatility.

Because individual risk factors can have material effects on the model's predictions, it is crucial to ensure these models are performing in line with *actual outcomes*. The problem is that no validation of model accuracy is provided in the FHA's actuarial report. The fact that the report provides sensitivity analysis of economic value outcomes across a range of simulated macroeconomic paths does not substitute for a validation of the models underlying the analysis. This is a critical omission in the report as there is no way of determining the accuracy of these individual models.

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[3] Annual Report to Congress Regarding the Financial Status of the FHA MMIF, Fiscal Year 2014, HUD, November 17, 2014, p.2.

[4] See 12 U.S.C.1831o.

[5] Annual Report to Congress Regarding the Financial Status of the FHA MMIF, Fiscal Year 2014, HUD, November 17, 2014, p.35.

One model that is critical to the macroeconomic scenarios underlying the actuarial results is the house pricing model. The diagnostic statistic (adjusted R^2) reported in the study that provides an indication of the model's ability to predict national home price changes was .654.[6] In many statistical applications, an adjusted R^2 of .654 should not be viewed as a providing a strong prediction of the underlying variable of interest (home price).[7]

For years, bank regulators have established guidelines for commercial banks to follow in the development of risk and valuation models. Models that are not validated in terms of their predictive quality against *actual experience* raise serious concerns from a regulatory oversight perspective. Specifically, in order for the FHA actuarial results to be considered robust and valid, the actuarial model developers need to demonstrate that each of the underlying models used in projecting MMIF economic value and insurance-in-force is predictive on a sample of loans *different* from those used to develop the models. In other words, standard testing of the model's accuracy needs to include examination of each model on its own merits.

Another problem is illustrated by flaws in the mortgage volume model used to project future FHA loan volume. This model has significant consequences for the actuarial results. The model depends on projections of the credit risk profile (based on borrower Fair Isaac Corporation (FICO) score and loan-to-value (LTV) ratio) of future FHA loans. Unfortunately, these figures should be, but are not, supplied by an actuary or some other *independent* source. Instead they come from the Department of Housing and Urban Development (HUD) itself. Specifically, the actuarial report states;

> These projected volumes are allocated among the three loan-product types (only for fully underwritten loans) following their distribution in the most recent endorsements over FY 2013Q3 to FY 2014Q2. HUD provided detailed projections of the compositions of these future books of business by LTV and credit score. Exhibits C-2 and C-3 present HUD's projected composition for for-purchase and fully underwritten refinance mortgages.[8]

In my opinion, this calls into question the independence of a key piece of information, as the credit risk profile of future books of business for FHA will certainly drive the actuarial model's results.

The approach taken in the actuarial model for generating an estimate of the economic value of the MMIF requires running each of these models of borrower default behavior through numerous scenarios (or paths) of house prices, interest rates, and unemployment rates. This

[6] Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2014, Integrated Financial Engineering, Inc., November 17, 2014, p. G-9.

[7] Note that R^2 ranges between 0 (no predictive power) and 1 (perfectly predictive, or that the model explains 100% of the variation in a dependent variable such as home price change due to the explanatory factors in the model). According to Financial Accounting Standard 133, for hedge accounting, an effective hedge is one where the unhedged risk is reduced from the hedge by at least 80%. The R-square or coefficient of determination provides a statistical measure of that degree of effectiveness. Thus, an R-square below 80% would thus not qualify as an effective hedge. See Rossi, Clifford. A Risk Professional's Survival Guide: Applied Best Practices in Risk Management, Wiley, 2014. Pg. 354.

[8] Actuarial Review of the FHA MMIF Forward Loans for Fiscal Year 2014, Integrated Financial Engineering, Inc., November 17, 2014, p. C-1.

process of simulating various possible macroeconomic outcomes that then drive different default outcomes is a standard analytical practice: a "Monte Carlo simulation". However, generating paths that are representative of future outcomes is reliant upon expert judgment in addition to good analytical practices applied to the data. The statistical models used to generate the simulated macroeconomic paths for projecting MMIF economic value are subject to considerable sensitivity. In other words, the simulated paths could produce outcomes that are wildly different depending on how clustered together or not the simulated economic paths are.

Moreover, the *number* of paths used to generate the actuarial model results is far too small to provide a robust understanding of the worst default outcomes that could possibly befall the MMIF over time. In modeling a portfolio of loans over time, the simulation generates a distribution of default outcomes, some better than the average and others worse than average. From an insurance perspective, understanding those outcomes at the far end of the distribution that result in credit losses under stress is essential to generating robust assessments of inherent credit risk in the portfolio. Generating 100 paths does not provide statistically reliable estimates of stress losses: for example, there is only one path that would designate the 99th-percentile worst loss. Many more paths would be needed in order to gain a more accurate view of the credit losses at the far end of the credit distribution. To get some perspective on this, consider that a recent study of the FHA MMIF by the Congressional Budget Office using a similar Monte Carlo simulation approach generated 1,000 economic paths in order to "account for uncertainty in the estimated parameters."[9] By relying on only 100 simulated economic paths, the FHA actuarial model does not adequately capture stress losses that would influence the magnitude of losses used to project economic value of the MMIF.

Another area that requires closer scrutiny is the data quality used to estimate the various models. The actuarial study clearly states that while the development team reviewed the data for integrity and consistency, they did not audit the data for accuracy.[10] In order to gain more comfort with the results, the actual data used to generate the actuarial model results should be independently audited.

The MMIF actuarial model is an appropriate methodology for analyzing the soundness of the MMIF. However, my testimony has identified a number of potential flaws in the model that could materially affect the results. Models are only representations of borrower and market behavior and so their limitations should be well understood before being used to make public policy decisions.

Impact of The FHA's Recent Decision to Lower MIP's

Beyond the model issues raised above, there are other significant issues that adversely affect the estimates produced by the actuarial model. One of these is the reduction in annual MIP premiums from 1.35 percent to .85 percent. The actuarial report did *not* take into account this change, which would clearly lower the revenues needed to build the capital reserve to its

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[9] "Modeling the Budgetary Costs of FHA's Single Family Mortgage Insurance," Francesca Castelli, Damien Moore, Gabriel Ehrlich, Jeffrey Perry, September 2014, Working Paper 2014-05, Congressional Budget Office, Washington, D.C., p.25.

[10] Actuarial Review of the FHA MMIF Forward Loans for Fiscal Year 2014, Integrated Financial Engineering, Inc., November 17, 2014, p. iv.

statutory threshold of two percent. This would *extend the timing* of when the Fund would be in compliance with the statutory threshold.

FHA sought to justify its reduction in premiums by saying that they far exceeded the amounts necessary to cover their newly insured mortgages.[11] But this *ignores* the higher expected losses on earlier insured loans. This is why comparing lifetime premiums on current borrowers to their projected average lifetime losses is not a meaningful comparison for a heterogeneous insurance portfolio comprised of a variety of borrower risk profiles over book years subject to different economic conditions. Moreover, comparing premiums to average losses overlooks the fact that even good book years and borrowers face some likelihood of experiencing a stress event, which must be taken into account.

In addition, beyond lengthening the time the MMIF finally reaches the two percent capital reserve ratio, lowering annual MIPs directly impedes the ability for private capital to support the housing market, which has been a stated objective of the Administration and market participants since the financial crisis. For example, in the 2014 Annual Report to Congress on the state of the MMIF, HUD explicitly stated that one of its missions was to reduce the FHA's footprint in the market and allow private capital to return.[12] With an average LTV of 94 percent for all FHA-insured loans endorsed in 2014, the agency effectively competes against high LTV conventional conforming loans insured by Fannie Mae and Freddie Mac.[13] Any mortgages insured by Fannie and Freddie with LTVs above 80 percent are required to carry private mortgage insurance. It is in this segment of the mortgage market that FHA's premiums introduce distortions by driving more loans to FHA when premiums charged for certain risk attributes such as FICO and LTV are lower than those charged by private mortgage insurers.

Lenders frequently perform what's called a "best execution" analysis for determining where to place a mortgage that they originate and this decision is based on which disposition (e.g., FHA or GSE-MI, or lender portfolio) generates the highest price among alternatives. The premiums charged by the GSEs, FHA and private mortgage insurers are critical inputs in this comparison. If guarantee fees charged by the GSEs and premiums charged by private mortgage insurance companies remain the same, *ceteris paribus*, then a reduction of 50 bps in the FHA annual premium could be expected to generally drive high LTV mortgages at the margin from the GSEs (and private mortgage insurance) toward FHA.

Notably, my recent research provides evidence that FHA/GSE(with private mortgage insurance) pricing differentials lead to FHA as the "best execution" (or more economical) for the highest LTV and lower credit-quality mortgages. With to the FHA premium reduction, borrowers

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[11] Testimony of Secretary Castro, "Prior to the decision to lower the annual premium, FHA was collecting almost four times the amount needed to cover the risk posed by its newest borrowers. According to the independent actuary, for new loans insured in Fiscal Year (FY) 2014, FHA will collect an average $17,000 in fees from borrowers over the lives of the loans. FHA expects that the average loss from borrowers for these loans will be $4,700." Written Testimony of Julián Castro Secretary of HUD, Hearing before the House of Representatives Committee on Financial Services Wednesday, February 11, 2015.

[12] Annual Report to Congress Regarding the Financial Status of the FHA MMIF, Fiscal Year 2014, HUD, November 17, 2014, p.7.

[13] Id. p.15.

with a 5 percent down payment and a FICO score of 680 or above are at risk of going to FHA when previously, private mortgage insurance was a good option for them. My estimate is that approximately eight percent of private mortgage insurance is at risk of being poached by FHA, if pricing/execution is the only factor in the decision. These FHA price reductions artificially wind up tilting market share toward the FHA and away from the private sector, exactly in contradiction to one of the stated objectives of the FHA mentioned earlier.

To better understand how mortgage insurance pricing between FHA, as a governmental entity, and private mortgage insurance can introduce market distortions, consider the following differences in how each prices its risk. A private insurer determines a fair premium to charge borrowers that covers its expected losses, capital cost, and administrative expenses, as well as a fair rate of return to its shareholders.[14] However, FHA is not bound by the same strictures. Instead, FHA has wide discretion in pricing its premiums, subject to the statutory cap on annual premiums, that should take into account expected losses, and administrative costs. Unlike its private-sector counterparts, FHA is not bound to price for the cost of their capital. This pricing advantage is exacerbated by other policy considerations at play in setting FHA premiums, namely the agency's mission to provide access to mortgages for first-time homebuyers and other segments of the market that tend to be associated with low - or moderate-income homebuyers, as we just saw in the stated reason for the FHA's premium reduction. For FHA, these policy factors lead to pricing outcomes that are not consistent with actuarial pricing *per se*, because there is a determination that from a policy perspective that the market is better served by providing a federal subsidy to expand credit in housing. That is a matter for public policymakers. However, this increases the advantage that FHA has as a federally subsidized insurer over private insurers in the market.

Further exacerbating the FHA's advantage over private mortgage insurance are differential capital requirements. Commercial banks and private mortgage insurance companies are subject to regulatory capital standards that are significantly above the two percent level required by the FHA for mortgage assets. Currently, private mortgage insurance companies operate at a minimum 25-to-1 risk-to-capital ratio, which relates to a four percent capital-to-asset ratio. However, risk-based capital standards under consideration by the Federal Housing Finance Agency (FHFA) would impose much higher capital ratios than four percent.[15] While imposing a set of risk-based capital standards on the private mortgage insurance industry is prudent, it underscores an important difference between private and public insurers that in a market where both compete for business, private capital is at a disadvantage. Reducing FHA's annual MIP exacerbates this situation, while further eroding the capital resources needed by the MMIF to achieve the two percent statutory capital reserve ratio.

In addition to increasing the FHA's footprint in the market, the recent premium reduction is likely to set off a refinancing wave. It is estimated that 2.4 million, or nearly one-third of all FHA borrowers, would have an incentive to refinance their mortgages due to lower MIP pricing.[16] While this clearly would benefit borrowers by reducing monthly payments, it also has

[14] To gain a better perspective on the mechanics of guarantee fee pricing for a GSE, refer to an analysis by Mark Zandi and Cristian deRitis, "Evaluating Corker-Warner," Moody's Analytics, July 2013, pp. 4-5.
[15] Draft Private Mortgage Insurance Eligibility Requirements, FHFA, July 2014.
[16] "More than one in three FHA borrowers could save money by refinancing today," Karan Kaul, Laurie Goodman and Jun Zhu, Urban Institute, February 16th, 2015

an impact on the prepayment speeds of the mortgage-backed securities that they are packaged into by Ginnie Mae. Investors in Ginnie Mae's securities have forecast typical inflows from the securities for an expected period of time, but this unexpected refinance wave could rapidly and dramatically increases prepayments, lowering the value of the Ginnie Mae securities. Ginnie Mae securities become de-valued because investors cannot count on the steady income stream of principal and interest for the same period of time they forecast when they purchased the security. The lost interest income makes Ginnie Mae securities much less valuable. The effect is that suddenly de-valued Ginnie Mae securities wreak havoc on institutional investors, like pension funds and life insurance companies that invest in Ginnie Mae securities, because they can no longer rely upon the predictable payment schedule.

Contributing Factors to FHA's MMIF Challenges

The question for policymakers, is what changes should be made to FHA that provide the agency with the best opportunity to fulfill its critical mission to housing while also protecting the taxpayer? Before proceeding to a set of specific recommendations, it is important to highlight a number of contributing factors to FHA's current financial situation and their implications for markets, borrowers, and the MMIF today.

Mission Conflict

The fact that the MMIF's capital reserve ratio stands at .41 percent is evidence that FHA's social mission may, at times, overshadow its financial mission. We now realize that a focus on market share without a healthy appreciation for risk was a recipe for disaster, and the lessons learned from this experience are as important to FHA, Fannie Mae, and Freddie Mac as they are to the private sector. At the heart of this issue are a host of governance, operational and oversight issues that explain excessive risks borne by FHA over the years.

These twin objectives for FHA may be in conflict. For example, in 2010, FHA imposed a minimum borrower credit score (FICO) of 580 as a way of improving the credit quality of new business. Up to that point, the lack of minimal standards on borrower creditworthiness clearly helped FHA expand its reach to borrowers with especially poor credit while significantly raising the risk to the MMIF. The mortgage industry has understood for years that borrowers with such marginal credit histories tend to have a likelihood of defaulting on their mortgages that may be as much as five to eight times higher than that of borrowers with FICO scores of 700 and above.

Moreover, FHA can adjust MIPs to affect desired public policy outcomes to serve its perceived social mission. For example, by holding down MIPs below what otherwise would be actuarially sound levels, it reduces costs to homeowners while passing them onto the MMIF (and ultimately, the taxpayer) through higher credit losses that manifest over time. Such policies allow FHA to serve a larger segment of the borrower population, but expose the MMIF to much higher risk long-term. Striking the right balance between FHA's social mission and its duties to maintain the MMIF's financial integrity is complicated, and made more difficult by a lack of clarity in defining who its target borrowers are. Such an exercise is about determining what segments of society merit public support, as well as about establishing a clear risk appetite that aligns to these goals.

Lack of Mission Clarity: Income Limits Needed

Turning to the social policy aspect of FHA programs, FHA's traditional role of serving low- and moderate-income borrowers has expanded into higher-income borrower segments that have access to private sources of insurance. This occurred because of a rapid increase in the upper limit on the size of mortgages FHA was allowed to, and subsequently pursued, insuring. Not surprisingly, it is borrowers with higher incomes who can sustain and/or afford the larger mortgages. Reliance on loan limits to determine FHA borrower eligibility, rather than on income measures, expands federal subsidies to borrower classes that do not need the federal subsidy.

To underscore the policy impact of current FHA loan limits, consider the following example: a borrower in the San Francisco Metropolitan Statistical Area can obtain a loan amount of $625,500. Given prevailing mortgage rates for a fixed-rate 30-year amortizing mortgage and including associated taxes and insurance on a $700,000 property, the monthly mortgage payment would be about $3,974. If the loan met the Consumer Financial Protection Bureau's (CFPB) Qualified Mortgage rules, the borrower would need to have a monthly income of approximately $9,242, or an annual income of about $110,900. The income requirements would be even higher if this borrower carried nonmortgage debt obligations, such as student loans. This income level far exceeds HUD's median family income estimate for California of $68,100.[17] While FHA continues to serve many low- and moderate-income borrowers today, there clearly is a need to revisit the social and economic rationale for current FHA loan limits, as well as consideration for implementing income-based limits.

Underinvestment in Risk Management

One manifestation of the heightened focus of FHA on its social mission to the detriment of the MMIF is the historical underinvestment in risk management resources, personnel, and technologies essential to managing a fund of such scale as the MMIF. In a study by the Government Accountability Office (GAO) conducted in 2011, a number of critical deficiencies in FHA's ability to effectively manage risks were identified.[18] These weaknesses resulted in the FHA absorbing excessive risks that it had little ability to identify before the risks had already been booked.

To put FHA's risk infrastructure into perspective, if the agency were subject to regulatory oversight by one of the bank supervisory agencies, it is likely that FHA would be subject to a number of examination findings on its risk-management activities. In assessing an institution's risk infrastructure, bank examiners focus on a number of critical areas, including the quality of an institution's governance structure for risk management; the adequacy and competence of risk staff; and quality of reporting, policies and procedures, data management and analytic capabilities, among others. A widely held perspective among bank regulators is that an institution's risk infrastructure must grow ahead of its lending activity. Without such attention to

[17] U. S. HUD. Estimated Median Family Incomes for Fiscal Year 2014. NOTICE PDR-2014-01. FY 2014 Median Family Incomes for States, Metropolitan and Nonmetropolitan Portions of States.

[18] These included staffing shortages in key risk management areas, a lack of adequate systems and capabilities to conduct proper surveillance of emerging risks and threats to the MMIF, delays in obtaining much needed resources and high turnover among key positions. Such findings are the hallmark of an organization not well-equipped to quickly identify, measure and manage risks. *See*. Government Accountability Office, Federal Housing Administration: Improvements Needed in Risk Assessment and Human Capital Management, GAO-12-15: Published: Nov 7, 2011. Publicly Released: Nov 7, 2011.

the quality of the risk-management process, an institution or agency in this case would be severely handicapped in an accelerated growth scenario, as FHA has experienced in recent years.

In addition, FHA has historically underinvested in robust portfolio surveillance capabilities. Once a loan has been originated, portfolio lenders retaining the asset on balance sheet typically engage in a number of activities to track the loan's default and loss performance against modeled outcomes over time and report material changes in defaults and losses to senior management. Changes in the economy, housing market, and individual borrower behavior must be closely monitored. Such early-warning mechanisms serve as the basis for effective remediation efforts to avoid default and adjust pricing, credit, and collateral policies, as well as trigger portfolio-level risk-mitigation activities. These capabilities are core to any large portfolio lender's risk function and are staffed with highly skilled risk professionals trained in advanced credit portfolio valuation techniques. Such techniques provide firms with an ability to more accurately assess and price credit risk by allowing combinations of risk attributes to be examined collectively across multiple economic scenarios over time.

Recommended Reforms to FHA

Ensuring the long-term viability of the MMIF while clarifying FHA's mission can be achieved by implementing a number of reforms aimed at addressing the contributing factors to the current challenges facing FHA. These reforms start with clarifying the role of FHA vis-a-vis other market participants, restructuring FHA to provide the agency with the flexibility and tools to manage its risks, strengthening its risk-management capabilities, and development of new risk-sharing and pricing frameworks to limit risk exposure and accurately price risk.

Provide Mission Clarity: Income Limits

First and foremost, FHA needs to get back to its historical roots of focusing on providing access to mortgage credit for low- and moderate-income borrowers. The size of the market should ideally be no greater than FHA's historical share of 10-15 percent. For years, median income targets have been used in various affordable housing programs. For example, the Federal Home Loan Banks' Affordable Housing Program provides subsidies to borrowers with median incomes at or below 80 percent of area median income. Likewise, affordable housing goals for both GSEs use the same 80 percent threshold of area median income in defining targets for Fannie Mae and Freddie Mac. FHA should adopt an area median income target to determine program eligibility and phase out the use of area-based loan limits. In conjunction with establishing income-based eligibility requirements, FHA should strengthen its requirements to ensure all eligible borrowers have the best chance of staying in their homes. This comes down to raising the bar on collateral, credit, and capacity criteria to repay the mortgage; namely, the "three Cs" of underwriting.

Allow FHA to Engage in Risk-Sharing Arrangements

Unlike many other holders of credit risk, FHA has no formal mechanism to transfer credit risk to the capital markets. As a result, FHA winds up holding 100 percent of the credit risk even though it may be economically advantageous to engage in risk-sharing arrangements with various market participants. For instance, both GSEs are required to have suitable credit enhancement for loans above 80 percent LTV. Private mortgage insurers provide first-loss coverage, depending on the LTV, between 25-35 percent. Such arrangements allow the GSEs to distribute risk across other counterparties rather than concentrate risk on their balance sheets.

Credit enhancements are also effective for reshaping the risk profile of the existing insured book. For example, large portfolio lenders and the GSEs from time to time will enter into reinsurance contracts with approved counterparties to sell portions of credit risk in their loan portfolios. Best practice portfolio risk-management exercises are not static, but rather, make regular adjustments to the risk profile of the insured book as market conditions or loan performance is anticipated to change. FHA should have the flexibility to enter into such arrangements, particularly with private mortgage insurance companies.

The FHFA has embarked on a number of credit risk-transfer structures with both GSEs and private investors to contract their balance sheets. As a way of both reducing the risk of the MMIF and initiating experience with such structures, FHA should begin to test a variety of credit risk-transfer structures with qualified counterparties. These qualified counterparties should, at a minimum, meet the same capital, reserve, and leverage ratios imposed on private mortgage insurers to ensure that such transactions have adequate support for the obligation.

Reduce the FHA's Guarantee below Its Current 100 Percent Level

Congress should reduce the FHA's guarantee below its current 100 percent level. An essential feature of mortgage insurance that is lacking in the FHA is the concept of coinsurance on the part of all parties to the transaction. For private mortgage insurance, coinsurance means that the private mortgage insurance stands in the first position of loss behind the borrower's equity and is generally 25–35 percent of the loan amount, which covers most (but not necessarily all) of the losses that the parties to the transaction experience. This serves as an important incentive to avoid foreclosure. FHA, on the other hand, insures 100 percent of the loan amount if the loan goes into foreclosure so that the loan originator lacks any meaningful risk of loss. As a result, the FHA guarantee does not properly align incentives between all parties and the FHA. Reducing 100 percent coverage will incent investors to require servicers to exhaust all viable loss mitigation options to keep the borrower in their home before resorting to foreclosure, and even conduct more prudent underwriting when originating a loan.

Qualified Mortgage Rule Harmonization

FHA makes the rules and guidelines for determining the eligible credit characteristics for consumers obtaining FHA mortgages. These rules and guidelines have been historically more liberal than those prescribed for conventional mortgages. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, passed in July 2011, CFPB was to construct the guidelines so that mortgages met the statutory "Ability to Repay" requirements. The CFPB did publish the Ability to Repay rules for conventional mortgages, but left to the discretion of the FHA the ability for them to write their own definition – which the FHA did. The conventional guidelines to meet the Ability to Repay rules create a mostly rigid qualifying ratio for consumers in that (generally speaking) the consumer's debt to income should not exceed 43 percent (note that the GSEs have an exemption for the first seven years of their conservatorship). The FHA published a similar standard – except that it allowed for discretion by the lender to use "compensating factors" in determining if a consumer should be authorized to exceed the ratio. This is a key issue because loans meeting the definition of the Ability to Repay requirements are granted a "safe harbor" limiting their extended liability. If the FHA definition of Ability to Repay is more liberal than conventional loans, lenders are likely to direct more loans to the more broad and/or liberal definition (provided by FHA) in order to reduce their liability.

This is a key issue in the comparison of FHA mortgages to conventional mortgages. Not only do lenders generally have to stay within the prescribed 43 percent ratio on conventional loans, but on mortgages with less than 20 percent down payment, lenders also have to ensure that the loan meets the private mortgage insurance standards of review for sustainability and documentation.

Furthermore, the actuarial report also reveals that FHA relies on a statistically-based automated underwriting scorecard, known as TOTAL, for approving all of its loans. Before and during the crisis, these models were oftentimes overused and, as has been proven, did not hold up well in accurately assessing risk when economic times changed. Old-fashioned underwriting can never be replaced by statistical models, and yet we find the agency relying on them more than the conventional market.

My recommendation is to avoid this type of forum shopping and require a single qualified mortgage standard that is applicable to both the conventional and government-insured market. This means that a single, qualified mortgage rule should permit loans that exceed the 43 percent debt-to-income ratio if the borrower has compensating factors (as the guidelines are defined by the FHA and/or as is in place in the GSEs underwriting requirements). For FHA loans that exceed the 43 percent debt-to-income standards, the loans should be manually underwritten by the FHA (e.g., the FHA Home Ownership Centers) rather than by lenders.

Tethered Analytics

FHA and the GSEs use different numbers when calculating key metrics in their respective risk models, which allows them to draw different conclusions about how to price future risk and the fees associated with that insurance. The calculations should be the same in order to avoid incongruous pricing policies between the GSEs and the FHA.

Concluding Remarks

Without question, FHA is an essential part of the housing finance system. While maligned for the current financial challenges of the MMIF, it is important to keep in mind that FHA has served this country well for nearly 80 years. However, the lack of a clearly defined mission for FHA along with potential conflict between its social and financial missions, are major contributing factors to the weakened state of the MMIF today. FHA reform must be undertaken to reduce the role of the federal government in the mortgage market, increase the role of private sector capital, and prevent future taxpayer bailouts. The agency requires a number of major reforms in order to put it on a secure financial footing that will ensure its important legacy for borrowers for the next 80 years.

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